S. HRG. 99-690

# EFFECT OF EXCHANGE RATE VOLATILITY AND THE DEBT PROBLEMS OF DEVELOPING COUNTRIES ON U.S. TRADE COMPETITIVENESS

## HEARING

BEFORE THE

## COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS UNITED STATES SENATE

NINETY-NINTH CONGRESS

SECOND SESSION

ON

THE NEED FOR POSSIBLE LEGISLATION THE UNITED STATES MIGHT TAKE TO DEAL WITH THE ECONOMIC DISRUPTIONS CAUSED BY THE RECENT DOLLAR MISALIGNMENT, DEBT PROBLEMS OF MAJOR DEVELOPING COUNTRIES ON THE U.S. ECONOMY, U.S. FINANCIAL INSTITUTIONS, AND THE U.S. INTERNATIONAL COMPETITIVE FOSITION

MAY 14, 1986

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# EFFECT OF EXCHANGE RATE VOLATILITY AND THE DEBT PROBLEMS OF DEVELOPING COUNTRIES ON U.S. TRADE COMPETITIVENESS

WEDNESDAY, MAY 14, 1986

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
*Washington, DC.*

The committee met, at 9 a.m., in room SD-538, Dirksen Senate Office Building, Senator Jake Garn (chairman of the committee) presiding.

Present: Senators Garn, Heinz, Gorton, Mattingly, Hecht, Proxmire, Riegle, Dixon, and Sasser.

## OPENING STATEMENT OF CHAIRMAN GARN

The CHAIRMAN. The Banking Committee will come to order.

Today the committee begins a series of hearings on the impact of recent dollar misalignment and the debt problems of major developing countries on the U.S. economy, U.S. financial institutions, and the U.S. international competitive position. We will also consider what steps the United States might take to deal with the economic disruptions caused by these events, including possible legislation to address these problems.

Dollar misalignment and the less developed countries [LDC] debt crisis have cost the United States billions of dollars in exports and they have done long-term harm to the export capability of many of our export industries. Merchandise trade deficits continued to climb last year and a significant turnaround of our trade accounts is not likely to come quickly.

I applaud the administration's initiatives in coordinating exchange market intervention and interest rate policies with the group of five [G-5] and in setting the stage at the Tokyo economic summit for intensified policy coordination intended to stabilize the world monetary system. These efforts are all aimed at promoting steady growth with stable exchange rates. It will be useful for this committee to have a better understanding of what the trade implications of these coordination efforts are likely to be. That is, how quickly and to what extent might we expect an improvement in our trade balance? In addition to price uncompetitiveness due to the high value of the dollar, U.S. exporters have been adversely impacted by the debt problems of developing countries. Not only have LDC imports from U.S. suppliers dropped dramatically, but the

availability of trade credits to finance those few exports which could take place has declined substantially as well.

We look forward to hearing the prognosis for recovery, what the prospects are for U.S. exporters to regain ground in the LDC markets, and what more needs to be done to bring about balanced LDC economic expansion.

These hearings, I believe, are very important to the committee, given the Senate's interest in taking up major trade legislation this year. If we are to avoid harmful, protectionist legislation, we must find a way to address productively our trade imbalance and the economic instability caused by current fluctuations and the LDC debt problem.

So we are happy to have witnesses, hopefully, before the hearing is over—hopefully. [Laughter.]

Senator Proxmire.

## OPENING STATEMENT OF SENATOR PROXMIRE

Senator PROXMIRE. I agree with you. People should realize that when Jake Garn has a hearing, he has it on time, and it started precisely at 9 o'clock.

This is the second in what I understand will be a series of hearings to review international debt and exchange rate issues as they relate to international trade and the massive U.S. trade deficit.

Yesterday, at our committee's joint hearing with the Finance Committee on these issues, Secretary of the Treasury James Baker said the administration has a viable strategy in place to deal with the trade and international debt problems that will confront us.

I am particulary pleased that as our first witness we will hear from Senator Bradley. Part of the reason the administration now has a strategy to deal with exchange rate volatility is due to the efforts Senator Bradley made to convince the administration its previous hands off approach was leading our country to disaster.

Senator Bradley is now very critical of this administration's international debt strategy. He believes we must put more emphasis on debt relief and less on new commercial loans to debtor countries. It will be interesting to hear him explain why.

It is also good to have Secretary Baldrige with us. He is on the front lines of our trade battle, and we need to know whether he shares the view that Congress need not give the administration any new tools to deal with our trade and debt problems. The fundamental question surrounding international debt problems in my view is whether it is a liquidity crisis or a matter of insolvency.

In a liquidity crisis, a country can be temporarily strapped for cash, but it is still basically creditworthy and new lending should continue.

If it is a matter of insolvency, then at least some of the debt is bad and will never be repaid. It should be written off.

Up until now, the U.S. Government has treated the debt problem as one of liquidity. So we find Secretary Baker calling on commercial banks and multilateral development banks to increase their lending to debtor nations. There have been reports in the press that European and Japanese banks have been more realistic in dealing with Third World debt and have written off large portions

of it, while American banks still maintain that they are good assets, because interest payments are being made. Some critics of the U.S. approach contend that it is like a giant Ponzi scheme, whereby our banks lend the debtor nations money to pay interest on the loans, so the banks, in turn, do not have to write them down.

Mr. Chairman, in our future hearings on this issue, I hope we can hear from our bank regulatory agencies and how they respond to the Ponzi scheme charges.

Other critics of the Baker plan contend that it creates a real conflict of interest for our bank regulators. On the one hand, we have reports in the press that a secondary market has developed for LDC debt in which banks can trade or sell portions of that debt for less than face value. This implies that the banks are admitting that some of that debt is not carried on the books at 100 cents to the dollar, and is overvalued. The catch is that if the bank regulators insist such loans are overvalued and should be reserved against, then the Baker plan will fail as the banks will not make new loans to these same debtor countries.

In our future hearings we should hear not only from the regulators but also from analysts of bank stocks and some of the bankers who are calling for a new realism in dealing with the International Debt Program.

Finally, I note, Mr. Chairman, that right after this hearing, we will continue the hearing we began yesterday on the proposed bill by the bank regulators to give them new powers to deal with the failing banks in Texas, Oklahoma, and other parts of the country. I wonder if the solution in that bill—that is, to give the regulators authority to sell failing banks to large money center banks—makes any sense. It would just result in a further consolidation of bad debts in the money center banks—when they are not being realistic in dealing with the questionable LDC debts that are already in their loan portfolio.

Thank you, Mr. Chairman.

The CHAIRMAN. Senator Heinz.

## OPENING STATEMENT OF SENATOR HEINZ

Senator HEINZ. Mr. Chairman, as you know, the Subcommittee on International Finance and Monetary Policy of this committee held a joint hearing yesterday with the Finance Trade Subcommittee on the international debt situation. We heard testimony from Secretary Baker, who had originally planned to appear before this committee. The hearing focused on improving the international economic environment by stabilizing exchange rates and helping resolve the LDC debt problems that Senator Proxmire referred to.

Today we are going to really look at the bottom line of those problems, insofar as they affect most Americans. We are going to be looking at their impact on our trade balance. We all look forward to Secretary Baldrige's testimony. He is in the midst of this difficult battle. To my mind, the administration initiatives to address the high value of the dollar and the LDC debt burden are focused on the most important factors contributing to the record trade deficits we are now experiencing. I hope that today we can

look at how the new spirit of international cooperation, after the Tokyo summit, will improve the situation and examine what else must be done.

I think the United States is doing its part for international cooperation. Our interest rates are coming down. The value of the dollar has been significantly reduced. U.S. imports continue to fuel world growth. We are making major efforts to reduce our budget deficits. Yet we see several developing countries once again approaching crisis in their ability to service their debt, and we, our trade imbalance actually growing worse.

The question that troubles me the most is whether our allies will do their part to solve these problems. The summit communique said many useful things, but it included no commitment by Germany and Japan to grow faster and thereby increase their consumption and their imports.

The inescapable fact is that with U.S. growth moderating and with the stimulative Federal deficits declining, the trade surplus countries must stimulate their economies to promote more balanced world trade and to help defuse the debt crisis by improving the export earnings of the developing countries. Obviously, if this country is going to export more and import less and the LDC debt countries are going to export more and import less, something has got to give.

Secretary Baker testified yesterday that there are distinct limits to improvement in our trade account through changes in exchange rates. Greater balance in world trade is going to be possible only through fundamental reform of surplus economies. This must include opening their markets to the developing countries and removing trade barriers, especially their nontariff barriers to U.S. exports.

Such fundamental change is the only way to reduce our deficit with Japan, which has been characterized as structural in nature.

The most recent report on milestones of progress in United States-Japan economic relations notes three major export gains for United States firms in March 1986. I think you will be impressed with them. The first gain is 100,000 cases of Miller beer. The second major gain is 500 tons of Florida oranges, and the third major gain is 8 American made cars, at least partly American-made, at any rate, including a 1985 Chrysler New Yorker as the official vehicle of the Ministry of Foreign Affairs.

Mr. Chairman, that's progress, or at least as defined by the Japanese. It really makes you feel that recovery is right around the corner.

We on the Banking Committee are anxious to hear from our witnesses, one of whom is with us now. We have great hopes for the rest—or the other, I should say.

I would only note, Mr. Chairman, I have another hearing on international trade this morning, and I imagine Bill Bradley is interested in it too, on the subject of the new negotiating round authority for the administration. I will have to absent myself, at least in part, this morning to attend that hearing. So if we have not concluded the hearing by 9:30. [Laughter.]

I hope to return at some point after that.

The CHAIRMAN. Thank you, Senator Heinz.

Senator Bradley, we are happy to have you with us today. Your timing was perfect, although you did miss some brilliant opening statements by members of the committee. You came in on the tail-end of Senator Heinz, but I am sure you will read our statements in the record.

Senator BRADLEY. Mr. Chairman, I am particularly sorry that I missed your brilliant opening statement.

Senator PROXMIRE. And you're not sorry you missed mine? [Laughter.]

Senator BRADLEY. And Senators Proxmire and Heinz.

Senator HEINZ. He's only half sorry to have missed mine.

The CHAIRMAN. Seriously, we are happy to have you before the committee this morning.

Please proceed.

## STATEMENT OF BILL BRADLEY, U.S. SENATOR FROM THE STATE OF NEW JERSEY

Senator BRADLEY. Thank you very much, Mr. Chairman. I appreciate the chance to come before the committee on this very important issue and cite a particular point of view about the Third World debt crisis.

Since the beginning of the debt crisis in 1982, debt management policies have stalled development in the Third World and have shrunk economic opportunity here in the United States. These policies have stood development economics on its head. For the past 3 years, resources have poured out of Latin America on their way to wealthy creditors. Latin American living standards have tumbled. The collapse of Latin buying power has cut off U.S. exports and destroyed U.S. jobs. Debt management today provides little fairness and no economic growth.

### IMPACT OF THIRD WORLD CRISIS

The Third World debt crisis has created a job crisis in the United States, a social crisis in Latin America and an ongoing menace to the world financial system. To pay their debts, Latin Americans must export, at any cost, and severely cut their imports. The result is a vanishing Latin American market for U.S. goods and a dramatic inflow of Latin American exports into the United States. The United States lost one-third of its exports to Latin America during the first year of the debt crisis.

The U.S. bilateral trade deficit with Latin America has deteriorated $23 billion since 1981. In other words, the trade deficit is $23 billion higher. By comparison, the United States bilateral trade deficit with Japan has deteriorated only $18 billion, and the elimination of all unfair trade barriers to United States exports would improve the trade deficit only $20 billion. So you see the significance of the debt crisis in Latin America for U.S. trade.

Altogether, 1 million U.S. workers have lost their jobs as a direct result of the debt crisis: 400,000 U.S. workers in the export sector have lost their jobs because there is no market in Latin America; and 600,000 U.S. workers have lost their jobs because of fierce import competition from Latin America.

And what has been the resulting benefit of these policies for Latin America? We know that the result in the United States has been significant job loss. Because Herculean efforts to stay current on their debt payments, together with capital flight, has created a recession in most of the region's countries, living standards have plummeted to between 8 and 19 percent in Mexico, Peru, Argentina, and Venezuela, since the early 1980's. The twin sacrifices of Latin American living standards and U.S. jobs have done nothing to diminish the threat of Latin default or of financial collapse in the United States. A widespread Latin American default would still wipe out the capital and reserves of the nine largest U.S. banks.

The economies and political systems of the inter-American community remain hostage to debt.

Mr. Chairman, we will not restore U.S. jobs or revive Latin American hope for progress, nor will we pull the financial system back from the hedge, until we change four facts of life in the Western community today.

First, we have to stop the perverse flow of resources from the poorest countries to the richest countries.

Second, we have to stem capital flight from the Latin American countries.

Third, we have to restore the confidence in Third World countries' economies, a confidence necessary for growth.

Fourth, we have to stop increasing the amount of debt.

Policies that have bled the resources of debtors, promoted austerity in the poorest countries and heaped new debt on old, simply kill the prospects for balanced growth in North America and Latin America alike.

## THE BAKER PLAN

Now as you are well aware, Mr. Chairman, Secretary Baker has announced a plan to provide countries implementing specific economic reforms with new commercial and multilateral loans. Initially, it called for commercial banks to put up about $20 billion and for multilateral agencies to provide $9 billion in extra loans over a 3-year period.

Whom would this go to? Any of 15 indebted developing countries that were willing to implement tax cuts, budget cuts, minimum wage cuts, and large-scale privatization would be eligible for loans under this plan.

Well, Mr. Chairman, my reaction to this is that the Baker plan is a welcome admission that the earlier policies of the administration and its view of Third World development really have reached a dead end; it is a 180-degree turn. According to the earlier view, indebted Third World countries had to engineer enormous trade surpluses to pay the debts. While they were competing fiercely with one another, the United States could sit back and run the world's largest trade deficit.

This view finally changed when the U.S. trade deficit became too painful to bear. But the Baker plan might not be such a radical departure for the administration. The plan relies on further bank lending and disregards the options of interest rate relief or debt

relief. But further lending, or new money will increase bank vulnerability, deepen Third World indebtedness, and spur capital flight to more than astronomical levels.

One Mexican official, for example, shared with me his understanding that of every dollar loaned to Mexico by a commercial bank, 50 cents comes back to Houston, or Miami, or Switzerland in the form of capital flight. In other words, the Baker plan prolongs the policies that created the crisis in the first place.

In addition, the conditions for receiving loans under the plan seem to preclude fresh initiatives generated by indebted countries themselves. Each country is different. Each might have its own set of economic ingredients that could, indeed, generate economic growth; but the conditions of the Baker plan are the same for all.

The only thing that could truly restore investor confidence in a Baker plan country is a successful economic initiative, designed, proposed, and implemented by the individual country, not a plan imposed from the outside.

## BACKROOM DEALS

Finally, the Baker plan continues to rely on backroom deals between bankers and finance ministers. These negotiations will take place behind closed doors, out of the view not only of U.S. workers who lost their jobs because of present debt policy but also of Latin American citizens who are most affected by them.

So in growth and fairness, I would reluctantly suggest that the Baker plan comes up short, even though it does represent a change in direction for the administration. Without making debt or interest rate relief part of the solution, the Baker plan will not spur long-term Latin American growth.

As I said, the plan proposes between $29 billion in new loans over the next 3 years, but the important fact is that this amount, the $29 billion, is less than the banks have been lending Latin America during the 3 worst years of the debt crisis.

During the 3 worst years of the debt crisis, new loans to Latin America were $45 billion. The Baker plan says, well, we are going to make that $29 billion.

In addition the Baker plan cannot diminish the vulnerability of the financial system to defaults. The only sound way to consolidate the system, I believe, is for banks to recognize losses on bad loans gradually over time.

The Baker plan calls for more debt, not less, $29 billion more, not less. This debt just returns to the banks in the form of interest payments or capital flight; 50 cents of every $1 comes back. No cash changes hands. Only the books look better.

If 50 cents of every $1 to Latin America in the form of a loan continues to pour back into the United States in capital flight, our loans will have no value.

Any plan that excludes debtor interest relief, cuts itself off from the only real hope of restoring growth.

There is another reason why the resolution of the debt crisis should include some form of debtor interest rate relief. Without it, the plan has little chance of creating incentives for long-term economic reform. Any incentives for positive performance, to move

people toward a more market-oriented system in these countries, which I think would be positive, will evaporate as soon as the loans are made.

Bank lending to Latin America has dropped off since 1982. No one expects commercial banks to resume lending the levels that they were in the 1970's.

But once the Baker plan has completed its lending—in other words, once the banks have put in money—there will be no reason for Latin American governments to comply further with Baker plan conditions.

Year-to-year interest rate relief, on the other hand, provides better long-term incentives because you have a year-by-year review. These are always interest payments to forgive.

Ultimately, Latin governments have to make basic changes to restore confidence, stem capital flight, encourage investment, and let markets work. Without explicit reliance on debtor initiatives, the Baker plan has the potential to destroy investor confidence in struggling debtor countries. Explicit reliance on debtor initiatives would recognize a new political reality in Latin America.

The three largest debtors are democracies, with increasingly competitive political systems. There is an increasingly volatile political climate in Mexico, in which plummeting living standards are an issue custom made for a demagogue.

If part of the plan is to cut out the middle class of the country, you are risking a violent political reaction.

ARGENTINA

The Peronists in Argentina are trying to make President Alfonsin pay for his pragmatic stand toward debt repayment.

Or even take Peru, where President Garcia is finding that his hardline position on debt, to limit payments to a certain percent of exports, has not isolated him from terrorism in his own country.

My point here is that we simply have to recognize the need for consensus building in these countries, and we have to challenge Latin America to solve its own problems and be prepared to commit resources toward plans that have some promise of success.

Now, my view, Mr. Chairman, is that an answer to the debt crisis doesn't have to throw Latin America into recession. A solution to the debt crisis doesn't have to lock the United States into a chronic trade deficit, deteriorating at the rate of $23 billion every 3 years with Latin America. And a solution should not postpone the problem with more of the lending arrangements that created the crisis in the first place. In other words, a bridge loan is a bridge to nowhere.

The proposal that I want to suggest this morning provides resources and incentives for economic growth, in a way that promotes fairness through the democratic processes of debtor countries.

In addition, what I will suggest could help us expedite a new round of multilateral trade talks, which I think are not only the key to long-term economic growth but would benefit all nations.

## ANNUAL FINANCIAL SUMMIT MEETINGS

So, Mr. Chairman, what I propose is, for lack of a better word—and I suppose if I were talking to a marketing consultant I would have a catchier word, but I don't have one for you this morning, but the general idea will come through—what I propose are annual financial summits to be held for the duration of a new trade round. I think this would sweeten the idea of a GATT round for many of the less developed countries that seem to be dragging their feet now.

The purpose of the summit meetings would be to promote developing country growth policies and expand markets for industrialized countries' exports. It would bring together commercial creditors, creditor governments, and multilateral agencies to recommend packages of commercial debt and interest rate relief together with new multilateral loans for specific debtor countries.

Indebted developing countries that successfully implement reforms to promote long-term growth, increase internal savings, and stem capital flight would be considered eligible for debt relief packages. The packages would be country specific and would reflect the judgment of the summit on the value of debtor growth programs.

The summit should include equal numbers of commercial creditors and creditor government representatives as well as the President of the World Bank. It should bring debt negotiations into the open and expose debt management to public scrutiny.

Now, what might a typical debt relief package consist of?

It would consist of maybe two points of interest rate relief on all commercial loans to a country for 1 year. Commercial creditors might also agree to write down 5 percent of the principal due.

The World Bank could undertake new project loans to the countries that it could disburse quickly through changes in acceptable project shares. Increasing the gearing ratio of World Bank lending would enable it to increase loan levels without waiting for a new capital subscription.

The World Bank should continue to explore the advisability of making structural adjustment loans where they increase the viability of the project.

This would be the debt relief package. It would be offered on a country-by-country basis with different mixes, depending on what the country itself said it was prepared to do to increase internal savings, stem capital flight, and promote economic growth.

The U.S. Government's summit representative would be guided by several principles, and I would suggest that these should be the principles evaluating debtor plans.

## DEBTOR GROWTH PLAN

First, a debtor growth plan should enjoy broad-based domestic support. Deals between debtor governments and creditor banks that impose harsh costs on the rank and file of the country are no better than deals that pay off banks while forcing U.S. workers out of their jobs. That is the first criterion, broad-based domestic support in the debtor country.

Second, the plan should rely on democratic processes. Specifically, the growth plan should be subject to the challenges of a com-

petitive political system, and its survival should reflect some form of broad political consensus. Actually, the second is a variation of the first.

Third, the plan should be immune from corrupt administration. Debt relief should not line the pockets of a corrupt elite.

The fourth criterion for a growth plan should be its ability to promote stable, noninflationary growth. That is what a growth plan is all about. But since growth is sporadic even in the most developed countries, other economic criteria are necessary.

The fifth criterion should be the ability of the plan to induce internal savings.

The sixth criterion, particularly relevant for Mexico and Venezuela, should be the ability of a debtor country plan to stem capital flight. The Nation's domestic investors, Mexicans, Venezuelans, Argentinians, simply must cope with their savings if foreign creditors are going to participate in development. The idea of sending new loans and having 50 cents of every $1 coming back just thwarts efforts to resolve the crisis.

Mr. Chairman, a financial summit that convenes creditors to recommend debt relief packages has strong potential to rekindle growth in developing countries. By opening the possibility of debt and interest relief, it will have enormous resources at its disposal.

Debt and interest relief will not exacerbate capital flight, and it will provide no fresh dollars. Debt relief has the potential to cut the debt overhang that stifles investment and growth in Latin America today, and since temporary interest rate relief can be reconsidered every year as long as the debtor country owes money, it can provide long-term, steady incentives toward healthy economic reforms.

Most important, debt and interest relief help debtors without increasing the vulnerability of the banks to default.

Some will argue that even moderate coordinated interest rate relief will hurt U.S. banks due to reserve requirements and accounting standards.

Mr. Chairman, my response is that for debt and interest rate relief to work for U.S. banks, a regulatory review board should consider changes in bank regulations and interpretations of accounting rules. We simply can't let regulatory habits block options for resolving the debt crisis.

A financial summit would promote fairness by opening debt management to public review. U.S. workers and ordinary Latin American citizens have borne most of the burden of the debt crisis, but U.S. banks and Latin American bureaucrats determine the solution.

Congress could give U.S. workers a vote through congressional oversight of U.S. Government participation in the financial summit.

Congress should enact a requirement for the Secretary of the Treasury to report on annual summit progress, specific debtor plans, what debtors are going to do to get economic growth, what kind of relief is provided and why.

Such a report would give Congress a voice on the adequacy of the specific packages. A financial summit would also promote fairness and build confidence in indebted countries through explicit reli-

ance on debtor initiatives, not on the solution imposed from the outside.

Mr. Chairman, I know you are quite aware that there are certainly more radical proposals to resolve the debt crisis than the one I have suggested today.

There are proposals to exchange Government loan guarantees for bank commitments to write down the debt, proposals to establish an international discount corporation to buy Latin American loans at a steep discount and force debt relief, plans to expand the scope of current proposals for a multilateral investment guarantee agency, plans to tie existing Latin American debt service payments to commodity prices, plans to cap debt service at a fixed percentage of debtor countries' exports, plans to require banks to forgive debt service in line with their reserve policies, and finally Mr. Castro's plan, which is to default on all of it.

Now, Mr. Chairman, none of these plans is without flaws. But strong U.S. leadership now would make the Draconian measures that each of these might entail unnecessary. Mr. Chairman, I would conclude by simply reminding the committee what it already knows, that after World War II the United States stepped boldly into the role of international economic leader and pathbreaker.

We recognized the need to rebuild Europe. The United States challenged Europe to propose plans for economic growth. They did, and we responded. The rest is the history of an unparalleled period of growth in Europe.

Today, Latin America needs rebuilding. Once again the United States has the opportunity to lead effectively, and frankly the United States should simply challenge Latin America to lay down long-term plans for growth, back them up with commitments, and propose a realistic role for its own creditors. We shouldn't have to wait for some cataclysm like war, or an earthquake, or partial default, or whatever to take these bold initiatives affecting the international economic system.

A financial summit on an annual basis tied to a new round of trade talks to recommend relief to specific debtors in exchange for promising growth plans awakens the prospect of expanding growth and fairness throughout the Latin American community.

Mr. Chairman, that is my lengthy but modest proposal this morning.

[The complete prepared statement follows:]

LDC Debt Testimony before Senate Banking Committee

Senator Bill Bradley

Wednesday, May 14, 1986

Since the beginning of the debt crisis in 1982, debt management policies have stalled development in the Third World and shrunk economic opportunity at home. These policies have stood development economics on its head. In the past three years, resources have poured out of Latin America on their way to wealthier creditors. Latin living standards have tumbled. The collapse of Latin buying power has cut off U.S. exports and destroyed U.S. jobs. Debt management today provides little fairness and no growth.

The Third World debt crisis has created a job crisis in the U.S., a social crisis in Latin America, and an ongoing menace to the world financial system. To pay their debts, Latin Americans must export at any cost and severely cut imports. The result is a vanishing Latin market for U.S. goods, and fierce Latin export competition. The U.S. lost one third of its exports to Latin America during the first year of the debt crisis. The U.S. bilateral trade deficit with Latin America has deteriorated by $23 billion since 1981. By comparison, the U.S. bilateral trade deficit with Japan has deteriorated by only $18 billion. Altogether, one million U.S. workers have lost their jobs as a direct result of the debt crisis. And what has been the resulting benefit to Latin America? Herculean efforts to stay current on their



debt payments, together with capital flight, have created a recession in most of the region's countries. Living standards have plummeted between 8% and 19% in Mexico, Peru, Argentina, and Venezuela since the early 1980's. The twin sacrifices of Latin living standards and U.S. jobs have done nothing to diminish the threat of Latin default and financial collapse in the U.S. A widespread Latin default would still wipe out the capital and reserves of the nine largest U.S. banks. The economies and political systems of the Inter-American community remain hostage to debt.

We will not restore U.S. jobs, revive Latin American hopes for progress, or pull the financial system back from the edge, until we change four facts of life in the western community today. We must stop the perverse flow of resources from the poorest countries to the richest, stem capital flight, and restore the confidence in Third World countries that is necessary for growth. And we must end the pile-up of debt. Policies that have bled resources from debtors, promoted austerity in the poorest countries, and heaped new debt on old, kill the prospects for balanced growth in North America and Latin America alike.

Secretary Baker has announced a plan to provide countries implementing specific economic reforms with new commercial and multilateral loans. Initially, it called for commercial banks to provide $20 billion and for multilateral agencies to provide $9 billion in extra loans over a three

year period. Any of fifteen indebted developing countries implementing tax cuts, budget cuts, minimum wage cuts, and large-scale privatization would be eligible for loans under the plan. This is a welcome admission that the Administration's earlier view of Third World development as international Darwinism reached a dead end. According to that view, indebted Third World countries had to engineer enormous trade surpluses to pay their debts. While they were competing fiercely with one another, the U.S. could sit back to run the world's biggest trade deficit. This view finally changed when the U.S. trade deficit became too painful to bear.

The Baker plan may not be a radical departure for the Administration. The plan relies on further bank lending and disregards the options of interest rate relief and debt relief. But further lending will increase bank vulnerability, deepen Third World indebtedness, and spur capital flight to more astronomical levels. In other words, the plan prolongs the policies that created the crisis in the first place. In addition, the conditions for receiving loans under the plan seem to preclude fresh initiatives generated by indebted countries, themselves. But the only thing that could truly restore investor confidence in a Baker plan country is a successful economic initiative designed, proposed, and implemented by that country. Finally, the Baker plan continues to rely on backroom deals between bankers and finance ministers. These negotiations will take



place behind closed doors, out of the view of the U.S. workers and Latin American citizens most affected by them. On growth and fairness, the Baker plan comes up short.

Without making debt or interest rate relief part of the solution, the Baker plan will not spur long-term Latin growth. The plan proposes $29 to $40 billion in new loans over at least three years. But this is less than the banks have been lending to Latin America during the three years since the crisis began. The Baker plan cannot diminish the vulnerability of the financial system to defaults. The only sound way to consolidate the system is for banks to recognize losses on bad loans gradually over time. But the Baker plan calls for more debt, not less. This debt just returns to the banks in the form of interest payments or capital flight. No cash changes hands. Only the books look better. Finally, if 50 cents of every dollar loan to Latin America continues to pour back to the U.S. in capital flight, our loans will have no value. Any plan that excludes debt or interest relief cuts itself off from the only real hope of restoring growth.

There is another reason why a resolution of the debt crisis should include some form of debt or interest rate relief. Without it, the plan has little chance of creating incentives for long-term economic reform. Any incentives for positive reforms created by the Baker plan will evaporate as soon as its loans are made. Bank lending to Latin America has almost dried up since 1982. No one expects commercial

banks to resume lending at the levels of the 1970s. Once the Baker plan has completed its lending, there will be no reason for Latin American governments to comply further with Baker plan commitments. Year-to-year interest rate relief, on the other hand, provides better long-term incentives. There are always interest payments to forgive.

Ultimately, Latin governments must make the basic changes needed to restore confidence, stem capital flight, encourage investment, and let markets work. Without explicit reliance on debtor initiatives, the Baker plan has the potential to destroy investor confidence in struggling debtor countries. Explicit reliance on debtor initiatives would recognize the new political realities in Latin America. The three largest debtors are democracies with increasingly competitive political systems. There is an increasingly volatile political climate in Mexico, in which plummeting living standards are an issue custom-made for demogogues. The Peronists in Argentina are trying to make President Alfonsin pay for his pragmatic stand toward debt repayment. Even President Garcia of Peru is finding that his hard line position on debt has not isolated him from terrorism in his capital. We must recognize the need for consensus-building in these countries. We must challenge Latin America to solve its own problems, and be prepared to commit resources to plans that promise success.



An answer to the debt crisis does not have to throw Latin America into recession or lock the U.S. into a structural trade deficit. And it should not postpone the problem with more of the lending arrangements that created the crisis in the first place. The proposal I want to make provides resources and incentives for growth. And it promotes fairness through democratic processes. In addition, it could help us expedite a new round of multilateral trade talks that would benefit all nations. I believe that the Administration should propose an annual financial summit to be held for the duration of the new trade round. This might sweeten the idea of a GATT round for LDCs that seem to be dragging their feet. The purpose of the summit meetings would be to promote developing country growth and expand markets for industrialized country exports. It would bring together commercial creditors, creditor governments, and multilateral agencies to recommend packages of commercial debt and interest relief together with new multilateral loans for specific debtor countries. Indebted developing countries that successfully implement reforms to promote long-term growth, increase internal savings, and stem capital flight, would be considered for debt relief packages. The packages would be country-specific and would reflect the judgment of the summit on the value of debtor growth programs. The summit should include equal numbers of commercial creditor and creditor government representatives, as well as the President of the World Bank. It should bring debt

negotiations into the open and expose debt management to public scrutiny.

A typical debt relief package might consist of two points of interest rate relief on all commercial loans to a country for one year. Commercial creditors might also agree to write down 5% of the principal due. The World Bank could undertake new project loans to the country that it could disburse more quickly through changes in acceptable project shares. Increasing the gearing ratio of World Bank lending would enable it to increase loan levels without waiting for new capital subscriptions. The World Bank should continue to explore the advisability of making structural adjustment loans where they increase the viability of its project loans.

The U.S. government summit representative should be guided by no more than six principles in evaluating debtor plans. First, the debtor growth plan should enjoy broad-based domestic support. Deals between debtor governments and creditor banks that impose harsh costs on the rank and file are no better than deals that pay off banks while forcing U.S. workers out of their jobs. Second, the plan should rely on democratic processes. Specifically, growth plans should be subjected to the challenges of a competitive political system, and their survival should reflect some form of broad political consensus. Third, the plans should be immune from corrupt administration. Debt relief should not line the pockets of a corrupt elite.



A fourth criterion for growth plans should be their ability to promote stable, noninflationary growth. Since growth is sporadic even in the most developed countries, however, other economic criteria are necessary. The fifth criterion should be the ability of the plan to induce internal savings. Without internal savings, a country can never be self-reliant. And the sixth criterion, particularly relevant for Mexico and Venezuela, should be the ability of the plan to stem capital flight. The nation's domestic investors must vote with their savings if foreign creditors are to participate in new development.

A financial summit that convenes creditors to recommend debt relief packages has strong potential to rekindle growth in developing countries. By opening the possibility of debt and interest relief, it will have enormous resources at its disposal. Debt and interest relief will not exacerbate capital flight, since they provide no fresh dollars. Debt relief has the potential to cut the debt overhang that stifles investment and growth in Latin America today. And since temporary interest rate relief can be reconsidered every year as long as a debtor owes money, it can provide long-term incentives to reward healthy reforms. Most important, debt and interest relief help debtors without increasing the vulnerability of the banks to a default. Some will argue that even moderate, coordinated interest rate relief will hurt U.S. banks due to reserve requirements and

accounting standards. For debt and interest relief to work for U.S. banks, a regulatory review board should consider changes in bank regulations and interpretations of accounting rules. We must not let regulatory habits block options for resolving the debt crisis.

A financial summit would promote fairness by opening debt management to public review. U.S. workers and ordinary Latin American citizens have borne most of the burden of the debt crisis. But U.S. banks and Latin American bureaucrats determine the solutions. Congress could give U.S. workers a vote through Congressional oversight of U.S. government participation in a financial summit. Congress should enact a requirement for the Secretary of the Treasury to report on summit progress, specific debtor plans, and summit debt relief packages. This would give Congress a voice on the adequacy of specifc packages.

A financial summit would also promote fairness and build confidence in indebted countries through explicit reliance on debtor initiatives. Open consideration of debtor initiatives would encourage developing countries to design, propose, and implement reforms through democratic consensus-building processes. Through its openness to public review, reenfranchisement of U.S. workers, and reliance on debtor initiatives, my proposal restores fairness to international debt management.



Plenty of more radical proposals to resolve the debt crisis are available. There are proposals to exchange government loan guarantees for bank commitments to write down debt; to establish an international discount corporation to buy Latin American loans at a steep discount and force debt relief; to expand the scope of current proposals for a multilateral investment guarantee agency; to tie existing Latin American debt service payments to commodity prices; to cap debt service at a fixed percentage of debtor exports; and to require banks to forgive debt service in line with their reserve policies. None is without flaws. But strong U.S. Administration leadership now would make these draconian steps unnecessary.

After World War II, the U.S. stepped boldly into the role of international economic leader and pathbreaker. Recognizing the need to rebuild Europe, the U.S. challenged Europe to propose plans for growth. Today, Latin America needs rebuilding. Once again, the U.S. has the opportunity to lead effectively. The U.S. should challenge Latin America to lay down long-term plans for growth, to back them with commitments, and to propose a realistic role for its creditors. We should not have to wait for cataclysms like war or earthquake to take bold initiatives affecting the international economic system. A financial summit to recommend relief to specific debtors in exchange for promising growth plans reawakens the prospect of expanding growth and fairness throughout the Inter-American community.

The CHAIRMAN. Senator Mattingly.

## STATEMENT OF SENATOR MATTINGLY

Senator MATTINGLY. Thank you, Mr. Chairman. I would like to place some questions in the record. I testified yesterday before the Senate Finance Committee on title 5 of the Omnibus Trade bill, S. 1866, which I cosponsored along with Senator Bradley in reference to the issue of LDC debt.

I would just say that I commend the Senator from New Jersey for his testimony. I believe that one of the strong points of our country is the fostering of new ideas, and ideas can change what happens in our world. I think that is what is so powerful about title 5 of the Omnibus Trade bill, and I hope, Mr. Chairman, that the appropriate committees and this Congress will pass this Omnibus Trade bill including title 5. I think it really will help to solve the current trade and LDC debt problems.

Mr. Chairman, I know you would agree that exchange rate volatility and burgeoning LDC debt have had a direct and harmful effect on this country's trade performance in recent years. While I disagree with those who would hold the high value of the dollar as the primary culprit responsible for our declining competitiveness, there is no doubt that an overvalued dollar or LDC debt should be considered as critical factors in overall U.S. trade performance.

Title 5 first sets out U.S. policy on exchange rates. It says coordination is necessary if imbalances in trade and capital flows are to be eliminated and exchange rates stabilized. Coordination of central bank participation in international currency markets is a reality supported by the agreement reached during the Tokyo economic summit. This is not to say that the process will be trouble-free; as I pointed out yesterday, it is delicate and depends on the cooperation of seven nations. We have already experienced the reluctance of Japan and West Germany to heat up their economies. In addition, I do not lightly dismiss concern expressed by Chairman Volcker and others that the decline of the dollar must remain manageable.

Title 5 also says it is in our own best interest to support the revitalization of the developing nations' economies. These countries can provide enormous market opportunities for U.S. exports. However, these markets have contracted rather than expanded in recent years as LDC's slowed imports and expanded their exports in the effort to earn the foreign exchange necessary to service their debt. Title 5 would provide financial incentives to those countries who adopt policies designed to encourage domestic economic growth.

Finally, we have all seen the disastrous results of continued expansion in areas of global overproduction such as agriculture and mining. Title 5 would authorize the President to enter into negotiations with members of the OECD and the multilateral development banks to prohibit funding of such unproductive use of resources.

Mr. Chairman, I will conclude my remarks by again calling for the adoption of a unified and coherent U.S. trade policy that makes specific improvements in our trade laws, but that also attempts to address the more macroeconomic issue of the state of the global economy and its impact on international trade flows.

Thank you.

The CHAIRMAN. Senator Proxmire.

Senator PROXMIRE. Thank you. I am going to have to go to the floor, unfortunately, very quickly.

MARSHALL PLAN FOR CENTRAL AMERICA

Senator Bradley, you propose a kind of a Marshall plan for insolvent Central America. The Marshall plan, as you know, was the most expensive foreign aid program this country has ever engaged in. Put in terms of 1986 dollars, even though South America is far smaller, economically, at least, than Europe, it would be an enormous expenditure on the part of our country at a time when, as we are all aware, we have the Gramm-Rudman-Hollings problem, and so forth.

Do you think that is practical?

Senator BRADLEY. Senator Proxmire, the analogy to the Marshall plan should not imply comparability of U.S. direct aid.

Senator PROXMIRE. That is what made it go in Europe.

Senator BRADLEY. The analogy is to the structure of the plan. That is, if you are going to challenge a region to make some tough decisions and develop its own growth plans, one of the things you do is to promise something that it wants. In Europe, the deal was, develop growth plans, we will give you some aid. What I am saying is here, Latin America must develop some growth plans, and we will provide some debt relief. Debt relief and interest rate relief.

Senator PROXMIRE. Both of which cost money.

Senator BRADLEY. It needn't cost public dollars. You have banks now that have rather short-term loans at rather high margins over London interbank offered rate [LIBOR], and if you were giving them more flexible accounting rules and if the prospect of growth in these countries would be enhanced, you could find more favorable terms from banks being the carrot that would, indeed, generate the growth in Latin America and Central America which we want. It needn't be public dollars. I recognize the budget stringency. Actually, that is one of the reasons that I offer this idea as opposed to more public dollars.

Senator PROXMIRE. In a speech you made on the debt crisis in Atlanta in April, you said that making new loans to Latin countries is a way of dealing with the debt crisis that will not work, because—and I quote:

> As much as 50 cents on every dollar of new loans to a country like Mexico will find its way to Miami real estate or Swiss bank accounts.

which is what you also testified again this morning.

James Henry, the author of an April 14 article in the New Republic, entitled "Where the Money Went," says that the wealthy elites of these debtor countries send their dollars out of their own countries in violation of their domestic laws and that American banks cooperate in the process. He further contends that as part of any plan to deal with the Third World debt problem, we must take steps to correct our own policies that encourage capital flights from LDC's.

What would you think of a law, and would it be practical to have a law requiring United States banks to cooperate with Mexico, for

example, and the Mexican Government in reporting funds coming from their countries? Do you think that would be effective, or would they simply send their funds elsewhere?

Senator BRADLEY. Well, given the fact that Panama is one of the favored havens, as well as various places in the Caribbean, as well as all of Europe, certainly, Switzerland, a simple United States reporting requirement, I think, could be easily evaded, if your idea were to get money out of the country and into some other place. What the reporting requirement would do would be to divert the flow of capital from the United States to other havens.

I think that is something that we could look into, but ultimately, what is going to stop capital flight is not a policeman at the border. Just as the Immigration Service is not going to have people all along the 2,000 mile border stopping the movement of illegal immigrants into the country. The thing that is going to keep illegal immigrants in Mexico and to keep capital in Mexico, is some belief on the part of Mexicans, that they have a good government, and that economic policies are in place that make it worthwhile for them to stay there and work and for them to invest there.

That is what this plan attempts to generate. It attempts to generate the will and also the payoff in these countries to develop economic growth policies, which could keep capital in the country, as opposed to forcing flight to other places, including the United States.

Senator PROXMIRE. Jeffrey Sachs, a professor of economics at Harvard, recently said that the current administration debt strategy is to secure full servicing of interest on Latin American debt. He believes the strategy is self-defeating, because it encourages high inflation and capital flight throughout Latin America, hurts U.S. exports and will reduce the ability of the debtor nations to make their payments. Under the current administration strategy of not granting debt relief, what would happen, if, in September, Mexico just runs out of foreign exchange and says it cannot pay any more interest on its debt, what do we do then?

### MEXICO OWES OVER $4 BILLION

Senator BRADLEY. Senator Proxmire, your guess is as good as mine, because that has never really happened before. As you point out, Mexico is in dire straits with the drop in the price of oil, they owe over $4 billion in payments, and soon they are going to owe more than that. Where are they going to get the money? If they don't have the money, what are their options? My guess is that the last thing they would like to do is to default. My guess is, they would come to the U.S. Government and say, as they have said to me from time to time, well, gee, we want to repay, but we just can't make the payment on time. So find some way to allow us to pay less over a longer period of time. And de facto, you would have, what I am arguing we should preemptorily achieve, a reduction of the debt burden that would give the country some room to breathe.

Now there is, I think, viewed in most financial and Government circles, a special relationship between Mexico and the United States. In other words, we would never let Mexico go. Well, I think it is a much more systemic problem than a bilateral problem.

So in answer to your specific question, I think the Mexicans would come and make their situation quite clear. We would provide some kind of assistance, buy oil from them, give them some relief in some other way, restructure their loans for a longer term, but we could not afford to allow Mexico to go down. And I don't think the Government is anticipating they would even consider that. But there is no policy here apart from a vague idea that, well, we'll all pull together. The Mexicans talked to me in January. They toid me that they might be able to live with the Baker plan—this was when oil was at $19 a barrel, $20 a barrel. They might be able to live with the Baker plan, if they could get $4 billion this year.

Well, that is not going to happen, and even then it wouldn't be enough, given the drop in the price of oil.

Senator PROXMIRE. Do you think the U.S. Government should either implicitly or explicitly guarantee against default any loans made by private banks to the debtor nations?

Senator BRADLEY. If you went the route of debt relief, the whole question of Government guarantee would be unnecessary. That is one of the advantages of debt relief. You don't have the problem of piling new debts on top of bad debts and making it even more a threat to the capital structures of banks and more unlikely that the countries would ever repay the principal.

So I would prefer to finesse the question of Government guarantees until we resolve whether we want debt relief or new loans.

Senator PROXMIRE. Debt relief would mean right now a loss on the part of the banks.

Senator BRADLEY. Debt relief would mean some loss on existing loan portfolios, if they were not restructured at lower interest rates.

Senator PROXMIRE. You have no idea whether or not such relief would result in such a situation for banks, that some banks might become insolvent?

Senator BRADLEY. I would say, essentially, that's what's been happening. Essentially, since 1982, you've had the regulatory authorities come into a bank and say, "Well, you know, you really have to move this into the danger category. You really have to think about writing this off," and many banks have gradually written off some of the private foreign debt, not the sovereign debt, but the private foreign debt. So that is happening de facto. And the whole debate is whether it should be done in a more systematic way. The argument there is, if you do it in a more systematic way, then you have clearly demonstrated that there is room for growth in these countries. If you do it in a kind of ad hoc way, you become a constant crisis manager. Well, perhaps Mexico can't repay. You create a crisis, and you skim through with the belief, ultimately, that somehow this amount of debt is going to be repaid somewhere, sometime, which I think is unlikely.

The CHAIRMAN. Senator Gorton.

Senator GORTON. Senator Bradley, I must say, I find your case impressive. I am inclined to think that some kind of debt relief is better than adding new loans to old ones. I am not exactly certain how we are going to accomplish that. I have very little confidence that those loans are going to be paid in full at market rate interest

rates, but I think you have made a very thoughtful case, and I commend you for it.

Senator BRADLEY. Thank you very much, Senator Gorton.

I think the key point is, you have to have—if you believe as you and I do, some kind of debt relief. The key thing is to devise a method that is flexible enough to recognize the individual differences and needs and potential of each country. That is why, in my statement, I suggest the annual financial summit in conjuction with trade talks, because this allows creditors and debtors to get together in a less politicized but more open atmosphere than the current arrangement and try to arrive at a growth-for-debt-relief strategy that will, indeed, have a prospect for success, as opposed to the present approach, which not only has little likelihood of success in terms of economics, but even more ominously, pushes some of our good Democratic neighbors into a political situation where it is inevitable that there is going to be a political backlash.

I would ask you simply to think of de la Madrid in Mexico, Alfonsin in Argentina, Sarney in Brazil, Sarazo in Guatemala, even Alan Garcia in Peru. These, and the smaller Central American countries that are now democracies, are attempting to answer the problem, which is fundamental to all of their countries. Namely, how do I deal with all this poverty? They are attempting to answer it in the context of a market-oriented approach, by and large. There are variations, but by and large, they want to be a part of the international financial system.

### POSSIBLE SUPPORT FROM CASTRO

Now if we cannot support that and give them some prospect of success, I can imagine another group of leaders down the road who will have quite a different answer to the problem of poverty in Latin America from these leaders, and I certainly don't want to provide any opening in Latin America for the Castro approach, which is default on everything. And I think that we owe it to these democratic leaders to give them the opportunity to lead within the context of a market-oriented economy, which ultimately benefits all of us.

In that same regard, I think we have to be resistant to protectionist pressures in this country to cut off our markets, as these countries begin to develop. At the same time, we shouldn't have banks force them to divert resources from their domestic market to the export market, simply to pay the loans at interest rates high above LIBOR and at very short term.

Senator GORTON. Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator Gorton.

Senator Bradley, we are pleased that you would take the time to testify before the Senate Banking Committee today. Thank you very much.

Senator BRADLEY. Mr. Chairman, thank you for giving me so much time. I actually thought you'd gavel me down and say, "10 minutes."

The CHAIRMAN. Well, Senator Dixon did say that he had to leave and that he had to put in an opening statement, which I will put in

the record for Senator Dixon along with Senator D'Amato's statement, but the rest of us were pleased to listen to you.

STATEMENT OF SENATOR ALFONSE D'AMATO

I want to extend the committee's gratitude to Secretary of Commerce, Mac Baldrige, who is before us today to discuss exchange rate, LDC debt, and other international trade issues. The United States is confronted with an unprecedented deficit in its trading account to the tune of $150 billion for 1985. Astoundingly, Japan accounts for one-third of this amount.

Shortly the Senate will consider trade legislation in an attempt to relieve the Nation of this crisis. Included in the omnibus trade bill, S. 1860, is a chapter designed to coordinate monetary and fiscal policies in order to eliminate trade imbalances and to stabilize exchange rates. Secretary Baker's meeting with members of the G-5 countries last September and their agreement to intervene and artificially lower the exchange rate has resulted in a devaluation of the dollar, especially against the yen. Although, the downward movement has been slow, this is good news for U.S. exporters. I would caution, however, that this extreme shift in U.S. policy be sparingly implemented.

Secretary Baker's plan for less developing countries, commonly known as the Baker initiative, is premised on an increase flow of funds to these debt-plagued countries. It is expected that commerical banks, the World Bank and the International Monetary Fund [IMF] will loan Mexico, Brazil and other LDC's more than $20 billion. I question whether there is strong justification for this policy or are we simply throwing good money after bad, especially when oil producing countries like Mexico are experiencing further debt problems due to the sharp reduction in oil prices. There is considerable risk in extending additional loans to these nations. Risks that should be closely evaluated before more money is loaned.

I welcome Secretary Baldrige's counsel to these trade-related matters and look forward to hearing his testimony.

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STATEMENT OF SENATOR ALAN DIXON

Mr. Chairman, I am pleased to be here this morning as the Senate Banking Committee continues its hearings on exchange rate and LDC debt issues.

At yesterday's hearing, I commented on the exchange rate issue and the role direct intervention can and should play in this area. Today, I would like to briefly comment on the LDC debt issue.

Let me say at the outset that I have the deepest respect for Secretary of the Treasury Baker, and that I appreciate the time and attention he has devoted to the Third World debt issue. However, I am concerned that the so-called Baker plan is nothing more than another Band-Aid, and I wonder about the desirability of piling still more debt on these countries.

U.S. banks are already terribly overexposed in Latin America, for example, where much of the debt problem is concentrated. Loaning additional sums, it seems to me, may not make much sense if they are only being used to pay the interest on old loans, and not on generating new economic growth in the countries involved. If new loans are primarily for this purpose, as seems to be the case, then neither the LDC countries or the U.S. banks benefit. We are buying time, but to what purpose, since the time isn't being put to good use.

I am not advocating necessarily cutting off further LDC lending for debt service purposes, or requiring banks to write down some of their LDC debt, but we must begin to address the fundamental problems behind the LDC debt crisis now. The LDC debt problems we have already experienced could grow much worse, with much more serious impacts on the U.S. banking system, unless we begin to do more than simply continue to put Band-Aids on this situation.

I know that Senator Bradley, our first witness this morning, has done considerable thinking on this issue, and I look forward to his testimony. I also hope the distinguished Secretary of Commerce will comment on this matter in the course of his remarks.

Senator BRADLEY. Let me thank you very much and just say once more how much I appreciate the chance to testify and how important this issue is and how important what this committee thinks about this issue will be.

The CHAIRMAN. There is no doubt about that. We have struggled with it for a long time, since we went through a very difficult period of the IMF quota increase a few years ago and the political implications of that.

Thank you very much.

Senator BRADLEY. Thank you, Mr. Chairman.

The CHAIRMAN. Secretary Baldrige.

Mr. Secretary, we are certainly honored to have you with the Senate Banking Committee today. Thank you for coming. We are pleased to see you.

## STATEMENT OF MALCOLM BALDRIGE, SECRETARY OF COMMERCE

Mr. BALDRIGE. Thank you very much, Mr. Chairman.

I am pleased to appear before this committee to discuss prospects for U.S. trade in light of developments in the area of exchange rates and LDC debt.

This hearing comes at a critical time for us as a trading nation.

Although I see improvement later in the year as the decline of the dollar dampens import growth and boosts exports, I expect a merchandise deficit for this year on the order of last year's—$148.5 million—perhaps a little less.

Imports have soared out of sight, and our exports down sharply since 1981, have shown only sluggish recovery.

Congress is responding to our trade situation by considering major revisions of our trade laws. For the most part, these revisions are protectionist and will undo much of the progress that the administration has already achieved in getting our trade picture back in focus.

### THE TRADE DEFICIT AND ITS IMPACT IN 1982

After nearly 70 years of capital outflows, the United States reached a peak international investment creditor position of almost $150 billion. Since then, successive large merchandise trade deficits have eliminated our creditor position and made the United States an international debtor. By the end of this year, our international debt will probably exceed that of any other country.

We got to this point through high foreign investment in the United States, low-growth policies of other countries, and stagnant export performance. The value of U.S. exports in 1985 was almost 9 percent less than 1981, while nonoil imports grew by 62 percent.

In those 4 years, our annual trade deficit has grown from $39.7 billion in 1981 to almost $150 billion in 1985.

Manufactures trade is the key component in these figures. Our manufactures trade performance deteriorated more rapidly over the 1980–85 period than our overall performance did. Manufactures trade has been and will continue to be the critical factor in U.S. merchandise trade and the dominant factor in our current account performance.

The growth in our trade deficits has had some positive effects. It has helped the world trading and international financial system during a period of severe strain. For example, it has permitted

LDC debtor countries to run large trade surpluses and finance interest payments on their foreign loans.

The strong economic growth underlying the deficit has provided a major part of the increase in European country exports that led their recovery from the 1981–82 recessionary period. In 1984, at the height of the recovery, we had twice the growth, in GNP, of all the other OECD members combined, and a rising standard of living to show for it.

And the trade deficit has assisted the export economies of the East Asian newly industrializing countries [NIC's] and other emerging economies.

But all this has come at great cost, Mr. Chairman. The widening U.S. trade deficit has been associated with painful adjustments in the U.S. economy, especially in our manufacturing industries. We cannot sustain these trade deficits and the growth of the U.S. debtor position indefinitely. The United States cannot continue to be the locomotive of the world economy. As I shall discuss further in a moment, our trading partners must be willing to share the burden of international economic stewardship. It is in their interest to do so, and we are working with them to take on some of the load.

It is commonly agreed that the high dollar is one of the major contributors to the trade deficit.

And, while the sharp depreciation of the dollar against many of the world's leading currencies since the end of February 1985 has not yet shown up in our trade performance, there are some encouraging signs.

As the dollar has fallen, we have seen evidence of rising orders in the manufactures sector. Exports rose substantially during the first quarter, from about $17 billion in January to nearly $19 billion in March. I am confident that we will start to see real evidence of the dollar's decline in the order books by the third quarter.

Imports also rose sharply in the first quarter—11 percent higher than a year earlier. This is due in part to the J-curve effect, where dollar depreciation causes the dollar value of imports to rise before the downward pressure on the volume of imports becomes effective. Moreover, import prices, excluding fuels, have begun to rise, increasing 3.4 percent in the first quarter of this year. I remain confident that our trade balance will begin to show considerable improvement in the latter half of the year, and that we will finish out at the same level as last year or slightly lower. The great increases of the last few years in the trade deficit are behind us.

### IMPACT OF THE DECLINING DOLLAR

But the recent dollar decline must be viewed in perspective, Mr. Chairman.

Although the high dollar is a major contributor to the deficit, we estimate that it still accounts for only about 40 percent of the problem. And while the dollar has fallen 30 to 40 percent against the yen and major European currencies over the last 15 months, it is still some 25 percent higher against the mark, 55 percent higher

against the pound, and 75 percent higher against the French franc than it was in its previous trough, in July 1980.

The dollar has fallen primarily against currencies which, together, account for about 40 percent of U.S. trade. It has remained steady against the Canadian dollar—Canada is our largest trading partner. It has stayed even with the peso—Mexico is our third largest trading partner—and with the East Asian NIC's. Most developing countries, including the dynamic East Asian NIC's, continue to tie their currencies closely to the dollar.

As to the effects of the dollar's decline on prices, Mr Chairman, there is some concern that further declines in the dollar may feed inflation. I don't share this view. While that may be the textbook view, I don't see it happening from the businessman's standpoint My reasons are as follows:

First, import prices didn't fall that much while the dollar was rising, so they shouldn't rise that much as the dollar declines.

For example, from August 1980 to February 1985 the dollar appreciated 59 percent on a trade-weighted basis, but nonfuel import prices fell only about 1.1 percent from December 1982 to March 1985.

Capital equipment prices fell only 7.8 percent from 1980 to 1985. Auto prices didn't fall at all during that period.

The dollar has fallen about 26 percent on a trade-weighted basis since February 1985. But nonfuel prices have risen only about 6.6 percent since then, and much of this increase can be attributed to noncurrency-related commodity price increases, such as coffee and sugar.

The second reason I don't see an inflationary outbreak, Mr. Chairman, is that foreign businesses have too much invested in this country—in production facilities, warehouses, distribution and marketing systems, advertising expenditures—to permit a loss of market share. They have got significant market share, they will fight hard to retain it, and they clearly have been making enough profit to take a price cut, maybe several price cuts if they have to keep market share. We're going to see increasing price competition down the road, and so as a businessman, I don't see prices going up nearly as much as the dollar has fallen. The process will be gradual rather than precipitous.

Mr. Chairman, you have indicated an interest in the LDC's. About one-fifth of the U.S. trade balance deterioration in recent years has been in our trade with the high-debt LDC's. Trade with Latin America is an example.

In 1981, we had a $3.1 billion trade surplus with the region. But in 1984, as a result of these countries cutting back on their imports because of a deterioration in their international creditworthiness, that surplus had become a $18 billion deficit—a $21 billion swing in 3 years. Our exports did go up by 15 percent last year, but are still well below their predebt crisis levels. The sharp drop in oil prices this year has made the financial difficulties of the oil-exporting, high-debt LDC's even more acute, while helping other LDC's?

The share of earnings from exports accounted for by oil for countries such as Mexico, Venezuela, Ecuador, Nigeria, and Indonesia is very high, ranging from over 50 percent to over 90 percent. So, with the price of oil now about half what it was at the beginning of

the year, their trade balances have been seriously damaged. Lower interest payments to private foreign creditors—largely induced by the drop in oil prices—will only slightly offset the sharp reductions in their foreign exchange earnings from oil exports. There may be higher import demand from industrial countries where economic growth will be boosted by the stimulus of lower oil prices, but not enough to make up the difference. There is a very serious situation developing there, Mr. Chairman.

On the other hand, oil-importing LDC's will be clear beneficiaries of the decline in oil prices. For some, the gain will be substantial. Brazil, for example, stands to save about $1.5 billion in expenditures on oil imports—assuming an average price of $15 a barrel this year compared with about $26 a barrel last year. Furthermore, reflecting the huge size of its debt, Brazil may pay over $1 billion less in interest this year than last. This would be the case if interest rates, as seems likely, average 1 to 1½ percentage points less in 1986 than they did in 1985.

On balance, the gains will outweigh the losses with the high-debt LDC's. But I do not wish to understate the seriousness of the situation that the oil-exporting countries, such as Mexico, now find themselves in, Mr. Chairman. It is clear that they are going through an extremely difficult period.

### CAPITAL FLIGHT

Another major problem that we are going to have to address with the LDC's is that of capital flight.

A recent study has estimated that capital flight over the last 10 years from 18 LDC's totaled about $200 billion, a substantial proportion of the $450 billion in new external debt that these countries were accumulating at the same time. The study concludes that, in the absence of such capital flight, the amount of foreign debt piled up would have been substantially less. It also points out that repatriation, rather than reinvestment abroad, of the earnings from such capital would have greatly eased the debt service burden of these LDC's.

Clearly, Mr. Chairman, the issue of capital flight must be addressed if the LDC's are going to make real progress in debt service or reduction. As a practical matter, it is just not realistic to expect further voluntary lending from abroad, whether public or private, when domestic funds are moving in the other direction. Capital flight must be reversed if there is to be any real prospect of additional funding. I don't believe we are going to accomplish this overnight, but the major elements of the Baker plan announced last October are all aimed at this problem, and I believe offer the best prospects for long-term improvement, which will occur, if we continue to work with the industrialized nations and the LDC's themselves to make it occur.

The plan contains three closely related elements:

Encouragement of the adoption by debtors of market-oriented exchange rate, interest rate, wage and price policies, as well as prudent monetary and fiscal policies favorable to investment. Removal of barriers to efficient and economic use of their own resources is a

necessary step to solving debt problems and economic growth problems in the developing countries.

A $9 billion increase in 1986–88 in multilateral agency lending to key debtor countries to support structural adjustment programs.

Increased commercial bank lending of $20 billion during the period to countries which introduce serious economic policy reforms.

Last September, Mr. Chairman, the President announced his comprehensive trade policy action plan. This plan includes elements intended to address what we view as the major impediments to increased world trade and economic stability.

We need to strengthen the functioning of the international monetary system through closer international cooperation.

The plaza agreement and subsequent coordinated actions by the major industrial countries have demonstrated our mutual commitment to working more closely together. The agreements made in Tokyo will build on this commitment. Key to the success of these arrangements is the ability and, above all, the willingness of the participants to coordinate their economic policies in a manner that minimizes large swings in external balances.

With the increasing integration of the world's economies, such cooperative efforts should be in everyone's self-interest.

We are promoting stronger and more balanced growth among the industrialized countries. We have to see better growth ahead. We've asked the finance ministers of the four industrial powers to take further measures to stimulate economic growth. While the U.S. economy has created over 20 million jobs in the last 10 years, Western Europe has lost 1½ million net private sector jobs. That has to be turned around in Europe, and the answer lies in additional noninflationary economic stimulus, as well as reduced intervention in the marketplace.

Our approach to the LDC debt problem is linked closely to our approach to our trade problems overall. An essential element of our strategy for economic adjustment and policy coordination is the constant pursuit of more open markets. American firms must be able to export into open markets if our trade deficit is to be substantially and permanently reduced. The LDC's must be able to export into open markets if they are to service their debt. Open markets promote world economic growth and foster world economic stability.

In this area, Mr. Chairman, we are vigorously enforcing our rights under the trade laws to ensure that American industry gets the fair shake it deserves. But we are going to be measured by our own performance.

### EFFECT OF CLOSING U.S. MARKETS

The Congress has before it a number of measures which would have, to one degree or another, the effect of closing U.S. markets.

We strongly oppose these measures. They would undercut everything we are trying to accomplish with our trading partners, both bilaterally and in the new round of trade negotiations. They would invite retaliation, which would hurt our exports and the 5 million American jobs that depend on our exports. They would hurt con-

sumers and encourage inefficiency and noncompetitiveness among our industries and add to inflationary pressures.

I urge the members of this committee to think twice before leading with their chins on international trade. The administration's trade policy is intended to promote our own prosperity as well as that of our trading partners. I urge you to give this policy your support.

Thank you.

[The complete prepared statement follows:]

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STATEMENT OF

MALCOLM BALDRIGE

SECRETARY OF COMMERCE

BEFORE THE

COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS

UNITED STATES SENATE

MAY 14, 1986

MR. CHAIRMAN AND MEMBERS OF THE COMMITTEE:

I AM PLEASED TO APPEAR BEFORE THIS COMMITTEE TO DISCUSS PROSPECTS FOR UNITED STATES TRADE IN LIGHT OF DEVELOPMENTS IN THE AREA OF EXCHANGE RATES AND LDC DEBT.

THIS HEARING COMES AT A CRITICAL TIME FOR US AS A TRADING NATION.

ALTHOUGH I SEE IMPROVEMENT LATER IN THE YEAR AS THE DECLINE OF THE DOLLAR DAMPENS IMPORT GROWTH AND BOOSTS EXPORTS, I EXPECT A MERCHANDISE DEFICIT FOR THIS YEAR ON THE ORDER OF LAST YEAR'S ($148.5 MILLION), PERHAPS A LITTLE LESS.

IMPORTS HAVE SOARED OUT OF SIGHT, AND OUR EXPORTS, DOWN SHARPLY SINCE 1981, HAVE SHOWN ONLY SLUGGISH RECOVERY.

CONGRESS IS RESPONDING TO OUR TRADE SITUATION BY CONSIDERING MAJOR REVISIONS OF OUR TRADE LAWS. FOR THE MOST PART, THESE REVISIONS ARE PROTECTIONIST AND WILL UNDO MUCH OF THE PROGRESS THAT THE ADMINISTRATION HAS ALREADY ACHIEVED IN GETTING OUR TRADE PICTURE BACK IN FOCUS.

THE TRADE DEFICIT AND ITS IMPACT IN 1982, AFTER NEARLY 70 YEARS OF CAPITAL INFLOWS, THE UNITED STATES REACHED A PEAK INTERNATIONAL INVESTMENT CREDITOR POSITION OF ALMOST $150 BILLION. SINCE THEN, SUCCESSIVE LARGE MERCHANDISE TRADE DEFICITS HAVE ELIMINATED OUR CREDITOR POSITION AND MADE THE UNITED STATES AN INTERNATIONAL DEBTOR. BY THE END OF THIS YEAR, OUR INTERNATIONAL DEBT WILL PROBABLY EXCEED THAT OF ANY OTHER COUNTRY.

WE GOT TO THIS POINT THROUGH HIGH FOREIGN INVESTMENT IN THE U.S., LOW-GROWTH POLICIES OF OTHER COUNTRIES, AND STAGNANT EXPORT PERFORMANCE. THE VALUE OF U.S. EXPORTS IN 1985 WAS ALMOST 9 PERCENT LESS THAN IN 1981, WHILE NON-OIL IMPORTS GREW BY 62 PERCENT.

IN THOSE FOUR YEARS, OUR ANNUAL TRADE DEFICIT HAS GROWN FROM $39.7 BILLION (1981) TO ALMOST $150 BILLION (1985).

MANUFACTURES TRADE IS THE KEY COMPONENT IN THESE FIGURES. OUR MANUFACTURES TRADE PERFORMANCE DETERIORATED MORE RAPIDLY OVER THE 1980-1985 PERIOD THAN OUR OVERALL PERFORMANCE DID. MANUFACTURES TRADE HAS BEEN AND WILL CONTINUE TO BE THE CRITICAL FACTOR IN U.S. MERCHANDISE TRADE AND THE DOMINANT FACTOR IN OUR CURRENT ACCOUNT PERFORMANCE.

THE GROWTH IN OUR TRADE DEFICITS HAS HAD SOME POSITIVE EFFECTS.



IT HAS HELPED THE WORLD TRADING AND INTERNATIONAL FINANCIAL SYSTEM DURING A PERIOD OF SEVERE STRAIN. FOR EXAMPLE, IT HAS PERMITTED LDC DEBTOR COUNTRIES TO RUN LARGE TRADE SURPLUSES AND FINANCE INTEREST PAYMENTS ON THEIR FOREIGN LOANS.

THE STRONG ECONOMIC GROWTH UNDERLYING THE DEFICIT HAS PROVIDED A MAJOR PART OF THE INCREASE IN EUROPEAN COUNTRY EXPORTS THAT LED THEIR RECOVERY FROM THE 1981-82 RECESSIONARY PERIOD. IN 1984, AT THE HEIGHT OF THE RECOVERY, WE HAD TWICE THE GROWTH [IN GNP] OF ALL THE OTHER OECD MEMBERS COMBINED, AND A RISING STANDARD OF LIVING TO SHOW FOR IT.

AND THE TRADE DEFICIT HAS ASSISTED THE EXPORT ECONOMIES OF THE EAST ASIAN NICS, AND OTHER EMERGING ECONOMIES.

BUT ALL THIS HAS COME AT GREAT COST, MR. CHAIRMAN. THE WIDENING U.S. TRADE DEFICIT HAS BEEN ASSOCIATED WITH PAINFUL ADJUSTMENTS ON THE U.S. ECONOMY, ESPECIALLY ON OUR MANUFACTURING INDUSTRIES. WE CANNOT SUSTAIN THESE TRADE DEFICITS AND THE GROWTH OF THE U.S. DEBTOR POSITION INDEFINITELY. THE UNITED STATES CANNOT CONTINUE TO BE THE "LOCOMOTIVE" OF THE WORLD ECONOMY. AS I SHALL DISCUSS FURTHER IN A MOMENT, OUR TRADING PARTNERS MUST BE WILLING TO SHARE THE BURDEN OF INTERNATIONAL ECONOMIC STEWARDSHIP. IT IS IN THEIR INTEREST TO DO SO, AND WE ARE WORKING WITH THEM TO TAKE ON SOME OF THE LOAD.

THE ROLE OF THE DOLLAR

IT IS COMMONLY AGREED THAT THE HIGH DOLLAR IS ONE OF THE MAJOR CONTRIBUTORS TO THE TRADE DEFICIT.

AND, WHILE THE SHARP DEPRECIATION OF THE DOLLAR AGAINST MANY OF THE WORLD'S LEADING CURRENCIES SINCE THE END OF FEBRUARY 1985 HAS NOT YET SHOWN UP IN OUR TRADE PERFORMANCE, THERE ARE SOME ENCOURAGING SIGNS.

AS THE DOLLAR HAS FALLEN, WE HAVE SEEN EVIDENCE OF RISING ORDERS IN THE MANUFACTURES SECTOR. EXPORTS ROSE SUBSTANTIALLY DURING THE FIRST QUARTER, FROM ABOUT $17 BILLION IN JANUARY TO NEARLY $19 BILLION IN MARCH. I AM CONFIDENT THAT WE WILL START TO SEE REAL EVIDENCE OF THE DOLLAR'S DECLINE IN THE ORDER BOOKS BY THE THIRD QUARTER.

IMPORTS ALSO ROSE SHARPLY IN THE FIRST QUARTER -- 11 PERCENT HIGHER THAN A YEAR EARLIER. THIS IS DUE IN PART TO THE "J-CURVE" EFFECT, WHERE DOLLAR DEPRECIATION CAUSES THE DOLLAR VALUE OF IMPORTS TO RISE BEFORE THE DOWNWARD PRESSURE ON THE VOLUME OF IMPORTS BECOMES EFFECTIVE. MOREOVER, IMPORT PRICES (EXCLUDING FUELS) HAVE BEGUN TO RISE, INCREASING 3.4 PERCENT IN THE FIRST QUARTER OF THIS YEAR. I REMAIN CONFIDENT THAT OUR TRADE BALANCE WILL BEGIN TO SHOW CONSIDERABLE IMPROVEMENT IN THE LATTER HALF OF THE YEAR, AND THAT WE WILL FINISH OUT AT THE SAME LEVEL AS LAST



YEAR OR SLIGHTLY LOWER. THE GREAT INCREASES OF THE LAST FEW YEARS IN THE TRADE DEFICIT ARE BEHIND US.

BUT THE RECENT DOLLAR DECLINE MUST BE VIEWED IN PERSPECTIVE, MR. CHAIRMAN.

ALTHOUGH THE HIGH DOLLAR IS A MAJOR CONTRIBUTOR TO THE DEFICIT, WE ESTIMATE THAT IT STILL ACCOUNTS FOR ONLY ABOUT FORTY PERCENT OF THE PROBLEM. AND, WHILE THE DOLLAR HAS FALLEN 30-40 PERCENT AGAINST THE YEN AND MAJOR EUROPEAN CURRENCIES OVER THE LAST 15 MONTHS, IT IS STILL SOME 25 PERCENT HIGHER AGAINST THE MARK, 55 PERCENT HIGHER AGAINST THE POUND, AND 75 PERCENT HIGHER AGAINST THE FRENCH FRANC THAN IT WAS IN ITS PREVIOUS TROUGH, IN JULY, 1980.

THE DOLLAR HAS FALLEN PRIMARILY AGAINST CURRENCIES WHICH, TOGETHER, ACCOUNT FOR ABOUT 40 PERCENT OF U.S. TRADE. IT HAS REMAINED STEADY AGAINST THE CANADIAN DOLLAR (CANADA IS OUR LARGEST TRADING PARTNER). IT HAS STAYED EVEN WITH THE PESO (MEXICO IS OUR THIRD LARGEST TRADING PARTNER), AND WITH THE EAST ASIAN NICS. MOST DEVELOPING COUNTRIES, INCLUDING THE DYNAMIC EAST ASIAN NICS, CONTINUE TO TIE THEIR CURRENCIES CLOSELY TO THE DOLLAR.

EFFECT OF DOLLAR'S DECLINE ON PRICES

AS TO THE EFFECTS OF THE DOLLAR'S DECLINE ON PRICES, MR. CHAIRMAN, THERE IS SOME CONCERN THAT FURTHER DECLINES IN THE DOLLAR MAY FEED INFLATION. I DON'T SHARE THIS VIEW. WHILE THAT MAY BE THE TEXTBOOK VIEW, I DON'T SEE IT HAPPENING FROM THE BUSINESSMAN'S STANDPOINT. MY REASONS ARE AS FOLLOWS:

FIRST, IMPORT PRICES DIDN'T FALL THAT MUCH WHILE THE DOLLAR WAS RISING, SO THEY SHOULDN'T RISE THAT MUCH AS THE DOLLAR DECLINES. EXCLUDING FUELS, IMPORT PRICES IN THE FIRST QUARTER WERE 6.6 PERCENT OVER THE COMPARABLE PERIOD IN 1985.

FOR EXAMPLE, FROM AUGUST, 1980 TO FEBRUARY, 1985, THE DOLLAR APPRECIATED 59 PERCENT ON A TRADE-WEIGHTED BASIS, BUT NON-FUEL IMPORT PRICES FELL ONLY ABOUT 1.1 PERCENT (FROM DECEMBER, 1982 TO MARCH, 1985).

CAPITAL EQUIPMENT PRICES FELL ONLY 7.8 PERCENT FROM 1980 TO 1985. AUTO PRICES DIDN'T FALL AT ALL DURING THAT PERIOD.

THE DOLLAR HAS FALLEN ABOUT 26 PERCENT ON A TRADE-WEIGHTED BASIS SINCE FEBRUARY, 1985. BUT NON-FUEL PRICES HAVE RISEN ONLY ABOUT 6.6 PERCENT SINCE THEN, AND MUCH OF THIS INCREASE CAN BE ATTRIBUTED TO NON-CURRENCY-RELATED COMMODITY PRICE INCREASES, SUCH AS COFFEE AND SUGAR.



THE SECOND REASON I DON'T SEE AN INFLATIONARY OUTBREAK, MR. CHAIRMAN, IS THAT FOREIGN BUSINESSES HAVE TOO MUCH INVESTED IN THIS COUNTRY - IN PRODUCTION FACILITIES, WAREHOUSES, DISTRIBUTION AND MARKETING SYSTEMS, ADVERTISING EXPENDITURES - TO PERMIT A LOSS OF MARKET SHARE. THEY HAVE GOT SIGNIFICANT MARKET SHARE, THEY WILL FIGHT HARD TO RETAIN IT, AND THEY CLEARLY HAVE BEEN MAKING ENOUGH PROFIT TO TAKE A PRICE CUT, MAYBE SEVERAL PRICE CUTS IF THEY HAVE TO KEEP MARKET SHARE. WE'RE GOING TO SEE INCREASING PRICE COMPETITION DOWN THE ROAD, AND SO AS A BUSINESSMAN I DON'T SEE PRICES GOING UP NEARLY AS MUCH AS THE DOLLAR HAS FALLEN. THE PROCESS WILL BE GRADUAL RATHER THAN PRECIPITOUS.

U.S. TRADE WITH THE HIGH-DEBT LDCS

MR. CHAIRMAN, YOU HAVE INDICATED AN INTEREST IN THE LDC'S. ABOUT ONE-FIFTH OF THE U.S. TRADE BALANCE DETERIORATION IN RECENT YEARS HAS BEEN IN OUR TRADE WITH THE HIGH-DEBT LDCS. TRADE WITH LATIN AMERICA IS AN EXAMPLE.

IN 1981, WE HAD A $3.1 BILLION TRADE SURPLUS WITH THE REGION. BUT IN 1984, AS A RESULT OF THESE COUNTRIES CUTTING BACK ON THEIR IMPORTS BECAUSE OF A DETERIORATION IN THEIR INTERNATIONAL CREDITWORTHINESS, THAT SURPLUS HAD BECOME A $18 BILLION DEFICIT - A $21-BILLION SWING IN THREE YEARS. OUR EXPORTS DID GO UP BY 15% LAST YEAR, BUT ARE STILL WELL BELOW THEIR PRE-DEBT-CRISIS LEVELS.

THE SHARP DROP IN OIL PRICES THIS YEAR HAS MADE THE FINANCIAL DIFFICULTIES OF THE OIL-EXPORTING HIGH-DEBT LDCS EVEN MORE ACUTE, WHILE HELPING OTHER LDC'S.

THE SHARE OF EARNINGS FROM EXPORTS ACCOUNTED FOR BY OIL FOR COUNTRIES SUCH AS MEXICO, VENEZUELA, ECUADOR, NIGERIA AND INDONESIA IS VERY HIGH, RANGING FROM OVER 50 PERCENT TO OVER 90 PERCENT. SO, WITH THE PRICE OF OIL NOW ABOUT HALF WHAT IT WAS AT THE BEGINNING OF THE YEAR, THEIR TRADE BALANCES HAVE BEEN SERIOUSLY DAMAGED. LOWER INTEREST PAYMENTS TO PRIVATE FOREIGN CREDITORS - LARGELY INDUCED BY THE DROP IN OIL PRICES - WILL ONLY SLIGHTLY OFFSET THE SHARP REDUCTIONS IN THEIR FOREIGN EXCHANGE EARNINGS FROM OIL EXPORTS. THERE MAY BE HIGHER IMPORT DEMAND FROM INDUSTRIAL COUNTRIES WHERE ECONOMIC GROWTH WILL BE BOOSTED BY THE STIMULUS OF LOWER OIL PRICES, BUT NOT ENOUGH TO MAKE UP THE DIFFERENCE. THERE IS A VERY SERIOUS SITUATION DEVELOPING THERE, MR. CHAIRMAN.

ON THE OTHER HAND, OIL-IMPORTING LDCS WILL BE CLEAR BENEFICIARIES OF THE DECLINE IN OIL PRICES. FOR SOME, THE GAIN WILL BE SUBSTANTIAL. BRAZIL, FOR EXAMPLE, STANDS TO SAVE ABOUT $1.5 BILLION IN EXPENDITURES ON OIL IMPORTS -- ASSUMING AN AVERAGE PRICE OF $15 A BARREL THIS YEAR COMPARED WITH ABOUT $26 A BARREL LAST YEAR. FURTHERMORE, REFLECTING THE HUGE SIZE OF ITS DEBT, BRAZIL MAY PAY OVER $1 BILLION LESS IN INTEREST THIS YEAR THAN LAST. THIS WOULD



BE THE CASE IF INTEREST RATES, AS SEEMS LIKELY, AVERAGE 1-1½ PERCENTAGE POINTS LESS IN 1986 THAN THEY DID IN 1985.

ON BALANCE, THE GAINS WILL OUTWEIGH THE LOSSES WITH THE HIGH-DEBT LDC'S. BUT I DO NOT WISH TO UNDERSTATE THE SERIOUSNESS OF THE SITUATION THAT THE OIL-EXPORTING COUNTRIES, SUCH AS MEXICO, NOW FIND THEMSELVES IN, MR. CHAIRMAN. IT IS CLEAR THAT THEY ARE GOING THROUGH AN EXTREMELY DIFFICULT PERIOD.

ANOTHER MAJOR PROBLEM THAT WE ARE GOING TO HAVE TO ADDRESS WITH THE LDC'S IS THAT OF CAPITAL FLIGHT.

A RECENT STUDY HAS ESTIMATED THAT CAPITAL FLIGHT OVER THE LAST TEN YEARS FROM 18 LDCS TOTALED ABOUT $200 BILLION, A SUBSTANTIAL PROPORTION OF THE $450 BILLION IN NEW EXTERNAL DEBT THAT THESE COUNTRIES WERE ACCUMULATING AT THE SAME TIME. THE STUDY CONCLUDES THAT, IN THE ABSENCE OF SUCH CAPITAL FLIGHT, THE AMOUNT OF FOREIGN DEBT PILED UP WOULD HAVE BEEN SUBSTANTIALLY LESS. IT ALSO POINTS OUT THAT REPATRIATION, RATHER THAN REINVESTMENT ABROAD, OF THE EARNINGS FROM SUCH CAPITAL WOULD HAVE GREATLY EASED THE DEBT SERVICE BURDEN OF THESE LDCS.

CLEARLY, MR. CHAIRMAN, THE ISSUE OF CAPITAL FLIGHT MUST BE ADDRESSED IF THE LDC'S ARE GOING TO MAKE REAL PROGRESS IN DEBT SERVICE OR REDUCTION. AS A PRACTICAL MATTER, IT IS JUST NOT

REALISTIC TO EXPECT FURTHER VOLUNTARY LENDING FROM ABROAD, WHETHER PUBLIC OR PRIVATE, WHEN DOMESTIC FUNDS ARE MOVING IN THE OTHER DIRECTION. CAPITAL FLIGHT MUST BE REVERSED IF THERE IS TO BE ANY REAL PROSPECT OF ADDITIONAL FUNDING. I DON'T BELIEVE WE ARE GOING TO ACCOMPLISH THIS OVERNIGHT, BUT THE MAJOR ELEMENTS OF THE "BAKER PLAN" ANNOUNCED LAST OCTOBER ARE ALL AIMED AT THIS PROBLEM, AND I BELIEVE OFFER THE BEST PROSPECTS FOR LONG-TERM IMPROVEMENT, WHICH WILL OCCUR, IF WE CONTINUE TO WORK WITH THE INDUSTRIALIZED NATIONS AND THE LDC'S THEMSELVES TO MAKE IT OCCUR.

THE PLAN CONTAINS THREE CLOSELY RELATED ELEMENTS:

- ENCOURAGEMENT OF THE ADOPTION BY DEBTORS OF MARKET-ORIENTED EXCHANGE RATE, INTEREST RATE, WAGE, AND PRICE POLICIES, AS WELL AS PRUDENT MONETARY AND FISCAL POLICIES FAVORABLE TO INVESTMENT. REMOVAL OF BARRIERS TO EFFICIENT AND ECONOMIC USE OF THEIR OWN RESOURCES IS A NECESSARY STEP TO SOLVING DEBT PROBLEMS AND ECONOMIC GROWTH PROBLEMS IN THE DEVELOPING COUNTRIES.
- A $9 BILLION INCREASE IN 1986-88 IN MULTILATERAL AGENCY LENDING TO KEY DEBTOR COUNTRIES TO SUPPORT STRUCTURAL ADJUSTMENT PROGRAMS.
- INCREASED COMMERCIAL BANK LENDING OF $20 BILLION DURING THIS PERIOD TO COUNTRIES WHICH INTRODUCE SERIOUS ECONOMIC POLICY REFORMS.



THE PRESIDENT'S TRADE ACTION PLAN

LAST SEPTEMBER, MR. CHAIRMAN, THE PRESIDENT ANNOUNCED HIS COMPREHENSIVE TRADE POLICY ACTION PLAN. THIS PLAN INCLUDES ELEMENTS INTENDED TO ADDRESS WHAT WE VIEW AS THE MAJOR IMPEDIMENTS TO INCREASED WORLD TRADE AND ECONOMIC STABILITY.

WE NEED TO STRENGTHEN THE FUNCTIONING OF THE INTERNATIONAL MONETARY SYSTEM THROUGH CLOSER INTERNATIONAL COOPERATION.

THE PLAZA AGREEMENT AND SUBSEQUENT COORDINATED ACTIONS BY THE MAJOR INDUSTRIAL COUNTRIES HAVE DEMONSTRATED OUR MUTUAL COMMITMENT TO WORKING MORE CLOSELY TOGETHER. THE AGREEMENTS MADE IN TOKYO WILL BUILD ON THIS COMMITMENT. KEY TO THE SUCCESS OF THESE ARRANGEMENTS IS THE ABILITY AND, ABOVE ALL, THE WILLINGNESS OF THE PARTICIPANTS TO COORDINATE THEIR ECONOMIC POLICIES IN A MANNER THAT MINIMIZES LARGE SWINGS IN EXTERNAL BALANCES.

WITH THE INCREASING INTEGRATION OF THE WORLD'S ECONOMIES, SUCH COOPERATIVE EFFORTS SHOULD BE IN EVERYONE'S SELF-INTEREST.

WE ARE PROMOTING STRONGER AND MORE BALANCED GROWTH AMONG THE INDUSTRIALIZED COUNTRIES. WE HAVE TO SEE BETTER GROWTH ABROAD. WE'VE ASKED THE FINANCE MINISTERS OF THE FOUR INDUSTRIAL POWERS TO TAKE FURTHER MEASURES TO STIMULATE ECONOMIC GROWTH. WHILE THE U.S. ECONOMY HAS CREATED OVER 20 MILLION JOBS IN THE LAST TEN

YEARS, WESTERN EUROPE HAS LOST 1½ MILLION NET PRIVATE SECTOR JOBS. THAT HAS TO BE TURNED AROUND IN EUROPE, AND THE ANSWER LIES IN ADDITIONAL NON-INFLATIONARY ECONOMIC STIMULUS, AS WELL AS REDUCED INTERVENTION IN THE MARKETPLACE.

OUR APPROACH TO THE LDC DEBT PROBLEM IS LINKED CLOSELY TO OUR APPROACH TO OUR TRADE PROBLEMS OVERALL. AN ESSENTIAL ELEMENT OF OUR STRATEGY FOR ECONOMIC ADJUSTMENT AND POLICY COORDINATION IS THE CONSTANT PURSUIT OF MORE OPEN MARKETS. AMERICAN FIRMS MUST BE ABLE TO EXPORT INTO OPEN MARKETS IF OUR TRADE DEFICIT IS TO BE SUBSTANTIALLY AND PERMANENTLY REDUCED. THE LDC'S MUST BE ABLE TO EXPORT INTO OPEN MARKETS IF THEY ARE TO SERVICE THEIR DEBT. OPEN MARKETS PROMOTE WORLD ECONOMIC GROWTH AND FOSTER WORLD ECONOMIC STABILITY.

IN THIS AREA, MR. CHAIRMAN, WE ARE VIGOROUSLY ENFORCING OUR RIGHTS UNDER THE TRADE LAWS TO ENSURE THAT AMERICAN INDUSTRY GETS THE FAIR SHAKE IT DESERVES. BUT WE ARE GOING TO BE MEASURED BY OUR OWN PERFORMANCE.

THE CONGRESS HAS BEFORE IT A NUMBER OF MEASURES WHICH WOULD HAVE, TO ONE DEGREE OR ANOTHER, THE EFFECT OF CLOSING U.S. MARKETS.

WE STRONGLY OPPOSE THESE MEASURES. THEY WOULD UNDERCUT EVERYTHING WE ARE TRYING TO ACCOMPLISH WITH OUR TRADING PARTNERS, BOTH



BILATERALLY AND IN THE NEW ROUND OF TRADE NEGOTIATIONS. THEY WOULD INVITE RETALIATION, WHICH WOULD HURT OUR EXPORTS AND THE FIVE MILLION AMERICAN JOBS THAT DEPEND ON OUR EXPORTS. THEY WOULD HURT CONSUMERS, AND ENCOURAGE INEFFICIENCY AND NONCOMPETITIVENESS AMONG OUR INDUSTRIES, AND ADD TO INFLATIONARY PRESSURES.

I URGE THE MEMBERS OF THIS COMMITTEE TO THINK TWICE BEFORE LEADING WITH THEIR CHINS ON INTERNATIONAL TRADE. THE ADMINISTRATION'S TRADE POLICY IS INTENDED TO PROMOTE OUR OWN PROSPERITY AS WELL AS THAT OF OUR TRADING PARTNERS. I URGE YOU TO GIVE THIS POLICY YOUR SUPPORT.

THANK YOU.

The CHAIRMAN. Thank you, Mr. Secretary.

The administration is to be congratulated for its leadership in the recent Tokyo summit, particularly in laying out a plan to deal with the currency misalignments. What response can we expect in our trade balance as a result of increased policy coordination agreed to in Tokyo? There have been a lot of press comments and editorials saying there was a great deal of talk over there and it sounded good, but we're not going to really experience any concrete results. What is your feeling and your response to those criticisms?

Mr. BALDRIGE. Well, first, Mr. Chairman, the largest reason for our trade deficit I think everyone will agree has been the strength of our dollar. You can argue about whether it's 30, 40, 50 or 60 percent, but it's the largest single element.

Beginning with the plaza meeting—actually, beginning in February before the plaza meeting the dollar was starting down. After the September meeting it started to go down more. We are now just beginning to see the results of that.

As I mentioned earlier, I am convinced that the last 6 months of this year we'll see a smaller trade deficit than we had the last 6 months of the previous year. So that's going in the right direction.

### NEED FOR INCREASING MARKETS ABROAD

The second thing we need is to have increasing markets abroad for our exporters to be able to export into. The situation we found ourselves in 2 or 3 years ago when the U.S. economy grew 6.8 percent, abroad in the European countries, the OECD countries, it grew about 1.7 percent. Our growing markets sucked in imports then but our exporters didn't have anything but a stagnant market to export to.

That's why we continually are urging the Germans, the Japanese, some of the other European countries that can afford to do it, to stimulate their economy by noneconomic means. It's going to help us and the LDC's both, and I think that for a variety of reasons we're going to see a much better growth in Europe this year than we did last year.

We have not been successful in getting the Germans to act beyond what I would consider the normal actions they would have taken anyway and the fact that oil price declines they feel are going to stimulate their economy in a noninflationary way sufficiently to answer our concerns.

But we believe that unemployment is the largest problem in Europe, not inflation. Inflation used to be the largest problem, but now it's maybe problem No. 4 or 5. That's why we're urging our European counterparts and the Japanese to grow their own internal economies at a more rapid rate so they do not have to depend on exports to dominate the leadership of their GNP growth.

The CHAIRMAN. Mr. Secretary, there's no one that disagrees on the fact that we need to find someway to stimulate growth. You're referring to Europe and, as discussed in Tokyo, the growth in Japan as well; but Senator Bradley spoke a great deal about the need for growth in the LDC's and suggested that rather than adding to their debt structure, we should be writing it down, reducing interest rates.

How do you feel about that? I believe you heard a good part of that.

Mr. BALDRIGE. Well, Senator Bradley described his plan as a lengthy but a modest proposal. Now when I hear that coming from a lengthy but modest Senator, there's a certain symmetry there that appeals to me. I always listen to Senator Bradley because I have a tremendous amount of respect for him.

In listening to him speak, without having had a chance to study this carefully, my first reaction was that in essence the plan that we have put forward and his plan are pursuing the same goals. We both want to increase the abilities of the LDC's to grow and change some of their internal policies that are hindering that growth.

When he talked about an annual financial summit, I can see the pluses in that. I can also see the minuses of the developing countries wanting to band together and make certain demands about debt relief, interest rate relief and so forth.

I think the major points we have to consider in whatever plan we look at is this, Mr. Chairman. All our discussions seem to hinge around debt, debt, debt. All you hear about is the debt crisis of the LDC's. You seldom hear equity mentioned, or investment. We had somewhat of a struggle at the OECD meetings to get investment included in the OECD recommendation for what would be taken up in the GATT round.

But there is a reason for the capital flight. I think Senator Bradley was being charitable when he said 50 cents out of every $1 goes back out of the country. Between 1983 and 1985 in some countries it was well over 100 percent. I mean we were literally seeing more capital flee than coming into some of the countries we're talking about.

As any businessman knows, you cannot fix up a debt problem without having, an adequate amount of equity to support the debt. You have to have the investment there—and the investment policies first to get the investment there—if they're going to be able to handle growth and solve their debt problem.

If all we look at is how to defer debt, how to lower interest rates, I don't think the LDC's are ever going to get out of this particular problem. They need very strong action on policies that promote investment, not just foreign investment from other investors abroad, but so that their own flight capital will continue to return instead of being invested in ski chalets up in Idaho or put in Swiss banks or whatever the myriad places there are to put flight capital.

So I can't emphasize that point enough. In my opinion, Mr. Chairman, we must see the kinds of policies in LDC's that encourage the creation and attraction of capital. We do not lean on that hard enough in any of our analyses. Without it, the debt problem will just consume the countries involved.

The CHAIRMAN. Mr. Secretary, I certainly agree with you. Sitting in this committee for several years, we do talk about the debt. We don't talk about equity investment. We continually talk about further loans rather than some means of trying to stimulate equity type investment.

But isn't there another problem? While we try to help the LDC's make structural changes within their own economies, the compen-

satory financing facility of the IMF only makes the situation worse and prolongs the adjustment by propping these countries up?

Mr. BALDRIGE. Yes; I can't say this is an administration position, Senator, but personally I have some problems with that. That certainly seems to work in a negative way in some cases.

The CHAIRMAN. Well, it certainly has. I have been on the compensatory financing facility's case for some time and it hasn't done any good, but in a number of areas it is just counterproductive to what we are attempting to do. I recognize what you said is not an administration position, but I'm glad to hear there's someone else who feels the way I do about it.

Senator Sasser.

## STATEMENT OF SENATOR SASSER

Senator SASSER. In the early years of the current debt crisis, which essentially began with Mexico's August 1982 announcement that it could not pay its debt obligations to foreign banks, the issue appeared to many Americans to be a distant one. It was viewed as a problem for poor countries and big banks. There was a sense that the U.S. Government and the multilateral banks would somehow arrange to avoid a crash. It didn't really seem to affect the man on the street here, so to speak.

With restructurings, negotiations, interventions, and austerity measures, the crash has indeed been avoided to this point. But we are also coming to understand the depth and breadth of the impact of this situation on American workers and American farmers.

What does it mean to American citizens that developing country debt is approaching $900 billion? That it has doubled in the past 4 years?

Some estimates indicate that it has meant 1.6 million American jobs in the past 4 years; 1.6 million jobs in lost exports and increased imports.

Developing countries have had to engage in frantic export promotion projects to earn the hard currency to pay their debts. They have been required to restrict their imports of foreign goods, including American projects.

The scramble for hard currency is especially evident in an example I cited yesterday in the joint hearing of our International Finance and Monetary Policy Subcommittee and the Finance Committee's Subcommittee on International Trade. The example emphasizes the central concern I have about the administration's approach—the Baker plan—that relies primarily on more of the same piling up of debt on top of debt, without adequate incentives for long-term improvement. Treasury Secretary Baker tried hard yesterday to assure me that the World Bank's structural adjustment lending would take care of the long-range problems. Considering the case involving soybean exports, I was not particularly assured by that statement. The numbers present a stark picture of what is happening. I want this example repeated for the benefit of the full Banking Committee.

Soybeans are critical to Tennessee's farm economy. Since 1981, U.S. soybean exports have fallen 36 percent. Meanwhile, Brazilian soybean exports were quadrupling and Argentina's were doubling.

The World Bank recently announced a $350 million loan to Argentina, pointing to it as proof that the World Bank can play its part in the Baker plan. However—and this is the key point—the loan is contingent on Argentina reducing its tax on agricultural exports, resulting in a projected increase in Argentinian agricultural exports—soybeans included—of as much as 6.5 million metric tons.

I think we might be well advised to take a harder look at the kind of structural adjustment lending that can be accomplished, with a little better direction, without further decimating our own economy.

With regard to our domestic economy, we cannot reasonably discuss global economies without addressing the U.S. inherent export capacity. The presence of the Secretary of Commerce makes that an especially relevant point this morning. It is true that a key element in the world trade equation is the opening of foreign markets—an element that in my opinion was not successfully addressed at the Tokyo summit, from the United States point of view. As I said, however, another part of the equation is U.S. export capacity. The goals of the Tokyo summit included an overall expansion of world trade, which is a worthy goal, but one which we can sustain only if there is an equitable balance of trade. We can sustain a major increase in imports, in other words, only if we are prepared to expand U.S. exports at the same time.

We receive testimony in this committee on the foreign export subsidies available to competitors of American business. The only rational response, in trying to rid the world market of these subsidies, is to remove that anticompetitive advantage by being prepared to match it. We have done our part on that score in maintaining the Export-Import Bank and reporting the war chest proposal to the full Senate. It is our hope and intention that the presence of a credible retaliatory threat will help our negotiators reduce world export subsidies in the long run.

Mr. Secretary, with regard to the problem of debt in the less developed countries, it appears to me that the thrust of the Baker plan is to try to solve this problem by lending these countries more money. As we lend them more money, the pressure is on them to pay back more.

And what we've seen on the part of some of the debtor countries, principally Argentina and Brazil, is a great increase in agricultural exports in an effort to pay back the funds that are owed.

### LOANS CREATE GREATER PRESSURE

Now I fear that if we lend them more money, there will be even greater pressure to increase exports—principally agricultural exports—because that's an export they can increase rapidly and without an extraordinary amount of effort. That's going to have a resultant damaging impact on our already damaged farm economy.

Just let me give you an example. One crop that I'm familiar with is soybeans. Now in my native State of Tennessee, soybeans are the largest cash crop in the State. We have seen over the past 4 or 5 years the acreage devoted to soybean production curtailed by 42 percent and, conversely, at the same time, we have seen Brazilian soybean exports quadruple and Argentina soybean exports double.

We are told that this is being done in an effort to get the foreign exchange to increase exports in an effort to deal with their debt crisis.

Now my question to you would be this: Aren't you apprehensive that if we go forward and lend these countries additional money that we're going to see increased pressure for them to increase exports, taking away additional export markets from American products—principally American farmers? Would you just elucidate that whole subject? It's a troubling one for me.

Mr. BALDRIGE. Yes, Senator; that's an immensely complicated question and I will do my best to answer it briefly.

You said that the essence of the Baker plan was to lend the LDC's more money.

Senator SASSER. Have I misstated that?

Mr. BALDRIGE. At least I thought I heard you say that.

Senator SASSER. I did say that.

Mr. BALDRIGE. Well, that's really only a part of it. The essence of the Baker plan is to lend more money to countries that show that they will welcome investment policies, policies that will reverse capital flight, encourage new investments, that will produce jobs, and will help them in paying off the debt if they were to get additional money.

So it's not really fair to mention one without mentioning the other because they are hooked together.

Having said that, you get into the whole area of investment capital. I don't want to take too long on this, but it's not just the policy of attracting foreign capital and reattracting your own flight capital in some of those countries. It's the myriad barriers that different South American countries have in particular to foreign investment. Even if a company wanted to invest in a Brazil or Mexico, in too many cases they can't or there are restrictions and the capital that would come in is being held back as a result of that, and those countries need every bit of equity capital they can get and some of their own barriers to that are some of the most backward-looking kinds of policies that they could adopt.

So when you talk about increased lending it should be done, in my opinion, with the other investment policies in place.

Now when you come to agricultural exporting, whether increased lending will stimulate that, we have right now large agricultural problems between the European Community and the United States.

Senator SASSER. Indeed we do.

Mr. BALDRIGE. We do; and unless we get those settled, that is going to be trade problem—as a matter of fact, it is now and it's going to be even more so—trade problem No. 1, not just between the European Community and the United States, unless we can get both our subsidies withdrawn or down to where we're closer to a market economy, but it's going to affect our agricultural trade relations with the South Americans and looking over the shoulder not too far you see the People's Republic of China about to become an exporter of grains and you see India, that no one ever thought 5 years ago was going to be a net exporter of wheat, all of a sudden in the last 2 years beginning to export wheat.

This is a worldwide problem. It is not just simply a South American problem. It has been exacerbated by our own U.S. Government agricultural policies. Our kinds of subsidies, whether it be price supports or other kinds of subsidies, have increased the price of U.S. farm goods and that has been a bonanza to a lot of nations outside the United States who are able to get a higher price for their grains now than they could if we hadn't pursued those policies.

SUBSIDIZING AGRICULTURE EXPORTS

Senator SASSER. Some of us, Mr. Secretary, are thinking that maybe one way to combat that would be to subsidize the agricultural export directly rather than subsidizing a farmer at the point of production because we are seeing that some of our trading partners in Europe are doing that.

Mr. BALDRIGE. I would say that that is looking at treating the symptoms and not the cause, sir. If we and the Europeans—and I don't think we could do this without the Europeans going along—if we could raise this issue to the highest level, work out a withdrawal, a phased withdrawal over an 8- or 10-year period of United States and European subsidies so that we would be talking more about market levels, the U.S. farmer can compete and hold his own anywhere in the world in agriculture. But as long as we keep the price artificially high we are providing an umbrella for all of the countries such as you're talking about to be able to—and sometimes through inefficient means—make a profit on exporting their grains.

We've got to back away from price supports and subsidies at least enough to get close to a market level, because otherwise all we do is encourage competition by our own policies of raising the cost of grain that high.

Senator SASSER. Let me ask this question. Mr. Secretary, with regard to new loans to the debtor nations, how eager are American banks to come forward and make additional loans pursuant to the Baker plan? Has any guarantee, either explicit or implicit, been given to American banks that the U.S. Government would stand behind some of these loans?

Now the reason I raise that point is the Heritage Foundation, as I understand it, has reported that American banks are not eager to make additional loans. In fact, they are reluctant to do so. They further report that implicit guarantees are being communicated that the U.S. Government would stand behind some of these loans. Are they in error on that?

Mr. BALDRIGE. I believe so, Senator. At least to my knowledge, the U.S. Government has given no guarantees to any commercial banks that we will stand behind guaranteeing their increased lending to the LDC's.

I think your statement is right that there is reluctance among the commercial banks to lend much more to South America for the obvious reason of the debt problems they have, but also because our banking laws are different—the accounting has to be different than it is in our industries. In industry, if you have a division that's in some trouble, some inventory that you think may be obso-

lete, you can write that down over a period of years at 10 percent a year for 10 years or 20 percent a year for 5 years, as long as you stick to that plan. In a commercial bank, if you have a loan that you think is a problem loan and that you'd like to write it off at 10 percent a year—you'd feel safer on 10 percent or 20 percent a year—you're not allowed to do it that way. You have to write 100 percent of it off—set up a debt reserve against it. That's not a very attractive proposition for U.S. banks.

Now I'm saying that it's administration policy that we should change that. I'm just saying that in my personal opinion we should look into it because that's one of the things if I was a banker I would be worrying about.

The CHAIRMAN. Senator Gorton.

### BEST COURSE FOR REPAYMENT OF DEBTS

Senator GORTON. Mr. Secretary, is it your view that there is even a 50-50 chance that the debts of the major Latin American countries to the United States will be repaid in full?

Mr. BALDRIGE. That answer depends completely—and I'll give a flat answer but it's got to have the one caveat in it. That depends completely on world economic growth. If we are in a stagnant international economy where total GNP is going up 2 percent a year or something like that, it's difficult to see how they could pay that off. That's one of the reasons that we—I know it gets tiresome sometimes—that we keep preaching against protectionism, because protectionism almost guarantees by the time the whole cycle is run with retaliation and what other countries do even if you didn't call it retaliation, it guarantees the whole world economic pie, the global pie, will not grow but very little. It would just get sliced up somewhat differently.

In that kind of a situation, for the LDC's to pay off their debt looks like a Herculean task. I wouldn't be able to bet on it.

On the other hand, if we have a noninflationary growth that's over—I don't know what the exact figure would be—but 3.5 percent, in that area, over 3 percent, yes, over time, I believe they can.

Senator GORTON. As I understand your position—and I do understand the chairman's position—the only, or certainly the most potentially successful, road to a solution for many LDC's is an infusion of new equity capital. This is much more likely to lead to economic salvation for them than increasing already burdensome loans.

Mr. BALDRIGE. Yes; there has to be some balance.

Senator GORTON. Given this position, do you know of any set of proposals from your Department, from other departments within the administration, or within the creditor private sector in the United States to transform a substantial portion of the present debt of LDC's into equity investments in those countries?

Mr. BALDRIGE. No.

Senator GORTON. Would that be a course of action worth at least pursuing and examining?

Mr. BALDRIGE. Well, it's been looked at, of course. A proposal has been brought up, if I understand your question, in several quarters to convert debt into equity. That really begs the issue. Unless you

have the policies in place to attract increased capital, increased investment, that's simply a stopgap measure and I think would encourage further LDC policies similar to what they've had in the past.

We've seen some courageous examples lately, not nearly to where we'd like to see them end up, but you have to say that in Argentina and Brazil there have been some courageous steps taken. I'd like to see some of the other countries be as courageous in doing it. But somehow, we have to get over that feeling in LDC political leadership that—oh, no, if we stopped subsidizing this group of exporters or if we stopped this import substitution or if we let your companies come into our country, there would be too much foreign ownership. Don't you see, Mr. Secretary, that's a political problem? So we can't do that—well, we've got to have politicians that are more courageous than that if we're ever going to get this problem solved. You can't solve it by just increasing the debt.

Senator GORTON. That does lead me to a question on a different subject. To what extent, if any, should the U.S. subrogate domestic economic objectives to achieve international economic stability?

Mr. BALDRIGE. Could you repeat that?

Senator GORTON. Are there any policies that we should take in the United States which might seem adverse domestically in the short run, in order to achieve international economic stability?

Mr. BALDRIGE. I think the first one is reduce the budget deficit. And again, that sounds like we're playing on an old, worn record, but——

Senator GORTON. I don't think we are subordinating our domestic interest when we cut our budget deficit.

Mr. BALDRIGE. No, I think that's in favor of our domestic interest, but that would help abroad. That's the point I was trying to bring out. It would help us but it would certainly help abroad and it would free up capital. We would not need so much from abroad. Not just free up capital for the LDC's, but it would free up capital in Europe. It could then, if the LDC's had the proper policies, go to the LDC's and so forth. It's all one integrated financial world now and every step like that we take has a major impact outside the United States as well as inside.

Now short of that, I think that our leadership for free trade is an absolute necessity for the LDC's. If we didn't keep our leadership, the political pressures on the Europeans, the Japanese, as well as the South Americans, would be extreme to go protectionist themselves, because their unemployment rate, except for Japan, is very high. In Europe it's 12 percent. They have extreme protectionist pressures on them.

If we once backed away from the leadership against protectionism, we would see that just almost automatically come into being around the rest of the world. That would hurt the LDC's more than any other group of countries and they just wouldn't be able to withstand that.

Senator GORTON. Thank you, Mr. Secretary.

The CHAIRMAN. Senator Riegle.

Senator RIEGLE. Thank you, Mr. Chairman.

Secretary Baldrige, I'm a big fan of yours as you know. I like you personally and I think you're a very important member of the Cab-

inet and I'm delighted that you're in the Cabinet and so I don't want what I'm about to say to be taken personally.

Mr. BALDRIGE. I'm wondering what's coming next.

Senator RIEGLE. Yes. [Laughter.]

I want to get you ready for it. I know you come out of the manufacturing side of the economy. You're about the only member of the administration that does and that I think really understands how that side of the economy works. We've got a lot of people around today in policy positions that shuffle pieces of paper and financial instruments but not very many that really have a background of making things, and selling them and selling them into the teeth of foreign competition.

LOSING OUR SHIRTS IN THE TRADE AREA

So when I say that I'm a fan of yours I mean that sincerely. Here's what bothers me. The United States is getting badly beaten in the trade area and, frankly, I think the administration is failing miserably to do the job. The fact is measured by the bottom line, the trade deficit. The deficit is out of control and you're not turning it around. You've been saying—you—I'm speaking collectively—the administration has been saying now for 4 years you're turning the trade deficit around. The trade deficit is not turning around. In your own statement today you say you expect the merchandise trade deficit for this year will be on the order of last year's deficit, $148 billion, perhaps a little less. Well, perhaps a little less isn't very helpful when we're into those kind of numbers.

We've just become a debtor nation. I'm really worried about that. I think becoming a debtor nation is a serious problem, not only because we haven't been a debtor nation since 1914 until this last year but also because of the speed at which we are increasing our foreign debt.

The New York Federal Reserve Board has recently estimated that between now and 1990, which is just 4 years from now, we're going to owe the rest of the world net something between $500 billion to $1 trillion. And I look at that and I say, "Who are the stewards here that are really getting the job done in reversing these numbers?"

I see these numbers as incredibly damaging to the country and to our financial prospects. I want to give you a specific case of a company I saw the other day in Michigan that you may be familiar with and that you'll understand given your own background.

The President went to the economic summit and didn't even take the trade representative with him and hear the Japanese basically laughing at us. They tell us they're going take action to open their markets to American goods. They haven't done anything of any particular consequence yet. Last month's trade deficit with Japan, despite the fall in the dollar, was the worst we've ever had. If the change in the dollar was helping us we ought to see it in terms of the bottom line. We're not seeing it in terms of the bottom line.

And I understand public relations as we all do, and that facts can be obfuscated to suit a particular position. You were coming from private industry, and you understand that if the bottom-line numbers continue to come out extremely negative month after

month, the policy isn't working. People can say, "Well, it's going to work some time in the future," but frankly, until we see some clear change in these trend lines. I don't think it's honest. I think it's misleading us, and I think we're getting into worse trouble.

The other day in the Wall Street Journal there was a summary of currency adjustments since early last year. It showed that we had a big change with respect to the Japanese yen, but we haven't had any basic improvement with respect to the currencies of Taiwan, Singapore, or Korea. These countries are killing us with imports and it's getting worse.

After Japan, Canada has the second largest bilateral trade surplus with the United States. We haven't had any gain on the Canadian currency despite this sharp drop in the dollar. So the fall in the dollar hasn't helped us with Japan, at least as far as we can measure. And then when you take all the other countries that are really eating us alive in the trade accounts, we haven't even had the promised benefit, of the currency improvement.

### SQUEEZE ON WOHLERT CORP.

I went out the other day and I'd like you to really think about this, not just in terms of what you might say today but what you think about when you go back downtown today and the days ahead. We have a sensational manufacturing company in Michigan by the name of Wohlert Corp. I don't know if you're familiar with it or not. They make machine rings and flywheels and they are one of the best in the country at doing that. To give you an illustration in the United States today they provide about 44,000 engines of all sizes, gigantic turbine engines down to small engines. They produce engine wheels for about 35,000 out of the 45,000 flywheels we produce in this country each day so it's clearly a strategic industry and they do a terrific job. It's a tough business to be able to have that kind of market share and hold it.

They have been facing competition from Japan and other countries now and they've been doing all the internal things they can do to change their manufacturing process. They've renegotiated their contracts. Their workers have negotiated a number of givebacks. Everybody is working as hard as they can and there's a great internal rapport in their plant.

They are now finding out there that there is a new company that's come on the scene selling engine rings and flywheels in the United States. It's a Korean company. They are underselling them on a $5 engine ring after they have squeezed the price down to get to a $5 level to hold off the Japanese pressure, a Korean company is now bidding on these same kinds of engine rings at a price of $3 versus their current price of $5.

Well, they can't handle this. There's no way they're going to be able to work down from $5 to $3.

And now we've got a tax bill that's probably in fact going to increase taxes for a lot of companies. It's uneven in terms of how it falls but it is certain that somebody in the business sector is going to pay that $100 billion over the next 5 years, and of that burden some may fall on them.

But even leaving that out of it, what do I say to a company like that or what do you say to them? Just hang in there, just keep working each day while we get eaten alive by these trading predators that are out there? We don't have a strategy today, with all due respect to Clayton Yuetter and everybody else that's on the team and so forth. We don't have a strategy that's working. I see business being devastated not just in my State but throughout the country, and we go through this sham of saying we've got a policy and things are getting better. Things aren't getting better. How long do we continue to put what I think is a mask over the problem when the problem is not getting improving?

It's getting worse and I don't want this company in my State or any other State to fail. This isn't an isolated incident. This is a pattern that's all across the manufacturing base of this country and I'm just sick at heart about it and at sort of at a loss. We're tinkering around the edges of the problem while we're losing millions of jobs. All this capital going out of the country, a net debtor nation. We're going to owe the rest of the world $500 billion to $1 trillion in just a 4-year period of time because we can't hold our own in this trade area and, frankly, I read your statement and I don't see anything there that really starts to turn this thing around.

So I don't know. Maybe you think I'm wrong. Maybe you think the picture I'm presenting here is wrong, but I'm telling you that's exactly what I'm seeing. I'm spending a lot of time on it. That's what business people are telling me. Where do we go from here?

Mr. BALDRIGE. Well, I have written down a note to myself, "Senator Riegle not too cheerful this morning" and we'll go from there. [Laughter.]

Senator, it really isn't true that we've been saying that the trade deficit is going to turn around for the last 3 or 4 years. I have never said that. Nobody that I know of in the Government has said that that had anything to do with trade.

We predicted within $1 billion actually, $1.5 billion, 1 year ago what last year's trade deficit would be. We didn't try and hide that fact.

### IMPROVING TRADE DEFICIT

I'll tell you, as sure as I'm sitting here, we're going to see the second half of this year—that's what you have to look at—the trade deficit significantly—I don't know how much, but significantly, not just $1 or $2 billion—less than the last 6 months of last year.

Now you picked up on the fact that I said the deficit as a whole for the year would be about the same, which is about as close as I can come to it right now, but that masks a significant difference. The first half of this year our trade deficit is going to be significantly worse than it was the first half of last year, but the second half of this year I think it's going to be significantly better than it was because the change in the dollar has not had a chance to affect sales yet.

It takes 18 months to 2 years for most of the products, particularly manufactured products. In the case of services, it can happen faster than that. But we haven't gone through that 12 to 18 months

yet. I mean, the dollar really began falling last September. So we're going to see a change in the last half of this year. I can see it coming and I can smell it coming and I'm willing to put my name on the line to that.

So when you talk about jobs, it's difficult for me to get into individual companies, but I want to point out something that I have to tell CEO's all over this country, not just in the case of your company but in the case of some companies that people have run pretty well—and I say run pretty well—until they ran into this international competitive factor.

This factor is not going to go away. U.S. manufacturers have to be able to meet it. They cannot hide behind the dollar anymore. That's gone down. They're going to have to be able to meet it either by getting better quality, higher technical standards, more automation, or whatever. I have sat and heard—and I don't think he would mind my using this example—Lee Morgan from Caterpillar, acknowledged as being one of the finest companies in the United States of America, just almost wiped out by the ascendency of the dollar because the Japanese company was quoting way below them, just about like your $5 to $3 price, and this was going on. Well, Lee Morgan worked to get the dollar down, but when he saw there wasn't going to be a quick fix in that area he went to work in his company and in what had been acknowledged as a very fine manufacturing company, they have taken between 25 and 30 percent of the costs out of there. And I know many more companies that have done the same thing, some as much as 35 percent—companies that were pretty well run before they did that. I know I've had to take 25 percent of administrative personnel out of the Commerce Department and the place runs better than it did before we had them. We are living in a New World as far as competition goes.

When the dollar is down to where it ought to be, we're going to have to be able to compete without any reason for failure other than somebody else either did it better or had lower costs some way, and that is not going to go away, Senator. We're going to be talking about that 10 years from now and 20 years from now and 30 years from now and, by a marriage of high technology with some of our basic industries, we have to pick them up. We're going to have to come up with new ideas and innovative techniques and, most of all, we're going to have to increase our own efficiency on the factory floor which is not as good as most other countries today.

We send all of our bright kids—I've seen this happen 100 times. When they get out of business school they all want to go up to the ivory tower and play around with computers at corporate headquarters. You don't see even 1 percent of them go down to the factory floor and learn about quality control and how to cut costs and how to lead people on the workforce.

I went to a Harvard Business School lunch where I had to give a speech the other day to alumni and I asked how many of them—and these were all bright successful men—who had come up through the factory and there wasn't one person who raised his hand. That's where we're getting whipped.

Senator RIEGLE. How many are there on the Reagan Cabinet that would raise their hand?

Mr. BALDRIGE. [Raising hand.]

Senator RIEGLE. That's the problem. Other than yourself?

Mr. BALDRIGE. I did.

Senator RIEGLE. I mean, you're surrounded by people who don't understand this problem and we don't have a strategy that's working. If you could just tell me, for example, how much our exports—our sales in Japan will increase in the last half of this year, which you cited over the last half of last year, I'd like to know what the number is, your best estimate today.

Mr. BALDRIGE. Right today? I'd say 5 or 6 percent.

Senator RIEGLE. It's going to go up 5 or 6 percent?

Mr. BALDRIGE. Yes.

Senator RIEGLE. Our exports to Japan of American goods for the second half of this year?

Mr. BALDRIGE. Yes; now that's an off-the-cuff guess.

Senator RIEGLE. But let's say it's right. I think if that's the best we're going to do after the enormous drop in the dollar and after all the promises of the Japanese to open their market if that's going to be the big turnaround, maybe we get 5 percent in the last half of this year which is supposed to be the boom half of this year, I think that helps explode the myth that this problem is going away. It isn't going away.

Mr. BALDRIGE. Senator, you have to couple that with their drop in our imports from Japan and, again, I don't know what that will be. But it has to be a combination of the two figures and this does not change overnight. I would not like to pin all of our hopes on the last half of 1986. I think 1987 will show the full strength of the effect of the dollar and we'll have to look at 1987 before we made up our minds whether it's actually working or not. I happen to think it will.

But, Senator, the U.S. Government cannot—when you say we have no plan for companies like you're talking about——

Senator RIEGLE. We don't have a plan that's working.

Mr. BALDRIGE. I don't know what plan to suggest and I have been in business for 30 years. As long as we have the right macroeconomic policies in place, American companies have got to be competitive themselves. There is nothing that the U.S. Government should do about subsidizing a company like you're talking about. That's not going to help them. I don't understand what people who want industrial policy mean by it. Who's going to pick who is going to get what subsidy and so forth.

Senator RIEGLE. Look, Mr. Secretary——

INTENSELY COMPETITIVE WORLD

Mr. BALDRIGE. Just let me finish this one point. I have seen manufacturer after manufacturer who still doesn't understand we are in an intensely competitive world for the rest of his life. He's still thinking back to the last three or four recessions when as soon as the recession is over you can raise prices and get back all you lost before and you don't have to worry about the foreign competition. It's here. It's not going away. We have to be able to compete in

that area. We can't turn to the Government and say, "Well, you've got to subsidize this or do this or that," as our policy.

Senator RIEGLE. Nobody is asking for that. I hope to have another round here because I want to continue this.

The CHAIRMAN. Senator Proxmire.

Senator PROXMIRE. Thank you, Mr. Chairman.

The CHAIRMAN. I would say before Senator Proxmire continues, we would be happy to give you another round. I've been generous with everybody today, but we do have another four witnesses so I hope we can go as rapidly as possible.

Senator PROXMIRE. You want to wrap the whole thing up by 11 o'clock and then go to the next witnesses?

The CHAIRMAN. Well, we're obviously not going to be able to wrap it up by 11, but as soon as possible thereafter.

Senator PROXMIRE. I'll try to be as brief as I can in my questions, Mr. Secretary.

Mr. Secretary, you were here when Senator Bradley testified and Senator Bradley proposed, among other things, a kind of a Marshall plan approach to the problems of Central and South America, but it was a Marshall plan without the money and that kind of puzzled me. That seemed to me like a wedding night without a bride. At any rate, it didn't seem to be exactly practical even though it left a lot for fantasy.

What did you think of Senator Bradley's proposal? He's obviously given it a lot of thought and I have great admiration and respect for him.

Mr. BALDRIGE. Yes, I do, too. I was just going to say the same thing. I have a great deal of respect for him. I always listen carefully when he has an idea.

This idea seems to me to take the core of the Baker plan which was to try and get proper investment and capital generating policies in place in the LDC's and if they would do that then you would help banks and the international banks get down and increase some lending. He said, "Well, let's do this same kind of thing at the finance summit but let's talk about debt relief there." And my answer to that is, I think it's so much more important to talk about how you get new capital in there. All we talk about is debt, how we're going to rollover the debt, how we're going to increase it, what the American banks are going to do and everything else.

You need an equity base much larger than they have in order to be able to handle the debt load they have. So I don't mean that we can stop talking about debt because it's there and it's a problem and we have to. But I think we have to emphasize very much more than we've been emphasizing the absolute need for policies to attract capital, new capital, and the return of the flight capital. That's been a horrendous situation.

Senator PROXMIRE. Policies on the part of these LDC countries?

Mr. BALDRIGE. These individual countries. In my job I run into policies all the time in South American countries that discourage joint ventures. They discourage foreigners from coming in there. It's just almost a willful discouragement because they don't want to be under the thumbs of the foreigners or they want to allow their own companies more of a chance to come up when they don't have the capital.

There's always a tradeoff in business, as there is in life in general, and the developing countries are not realizing the benefits that they could realize in getting their own flight capital back by changing their policies and it would take some courage to change them. But we're beginning to see some changes in Brazil and Argentina. I'd like to see more of it in Mexico. But there's not enough yet.

DOLLAR-YEN EXCHANGE RATE

Senator PROXMIRE. When you appeared before our committee in February you told us that the major cause of our trade deficit was the overvalued dollar. Since February the dollar has continued to decline in relation to the Japanese yen. Today it is about 161 yen to the dollar. The Washington Post reports today that the Japanese Finance Minister stated on Monday that the dollar's fall has been excessive and said Japan will intervene in currency markets to prop up the dollar.

Do you agree with the Finance Minister that the fall of the dollar has been excessive and what do you think would be a fair dollar-yen exchange. I understand the Japanese believe it should be about 180 yen to the dollar.

Mr. BALDRIGE. Well, I don't think it's been excessive.

Senator PROXMIRE. You think it's about right now?

Mr. BALDRIGE. We don't have—I think as you know, Senator, we don't have a target for the dollar-yen rate. Now you can read that statement I suppose anyway you want, but we don't have a target for it. And I know the Japanese think it's fallen too rapidly. We don't think the fall has been excessive. We don't have a rate that it ought to be at. So you can I suppose, read that statement anyway you want to.

Senator PROXMIRE. Don't you think we ought to have some goal?

Mr. BALDRIGE. No; we think the market ought to decide. That dollar went up awfully rapidly and you didn't hear too many people kicking about that outside the United States.

Senator PROXMIRE. But when the market went up so rapidly the Secretary of the Treasury took steps with other countries to try to bring it down and he succeeded.

Mr. BALDRIGE. Well, that was in 1985 in the fall and——

Senator PROXMIRE. He didn't wait for the market to do it automatically, did he?

Mr. BALDRIGE. Yes, sir; I think if you look back you'll find that the dollar started to fall in February 1985.

Senator PROXMIRE. You mean that Baker meeting that took place didn't influence that?

Mr. BALDRIGE. It may have influenced the speed, but not the direction. The direction was definitely established from February 1985 until the fall of 1985 and we didn't think that the underlying economic fundamentals—we thought they were in place so that the dollar should fall and this was causing problems around the world, not just the United States. The Europeans were complaining about our dollar, as they love to complain about most of our policies, but this time the high dollar that benefited them on trade flows they were saying was sucking all the capital that they could have used

to expand their industry into the United States instead. So it was a worldwide decision really.

Senator PROXMIRE. On page 8 of your testimony you note the severe difficulties that Latin America export countries are now encountering because of the fall in oil prices. You note, "Their trade balances have been seriously damaged. There's a very serious situation developing there." And you leave it at that.

Now what plans are we developing to deal with that situation and what will we do if in September Mexico says it does not have the foreign exchange to pay any more interest on its debt because of falling oil prices? Where will that leave our money center banks?

Mr. BALDRIGE. I don't imagine they would be too happy, Senator.

Senator PROXMIRE. I agree with that.

Mr. BALDRIGE. I think the policy that we have is the only one that I know of that is going to work. Now whether you have it by individual meetings or a summit meeting is technique, but unless we can get the developing countries to attract more capital in there—I know I sound like a broken record—they are not going to be able to handle the debt problem. That is our policy.

If they would put in policies receptive to freedom of capital movement, safety of capital, all of the things that attracts capital in there and get their flight capital back, that's answer No. 1. Unless they can get their flight capital back and put in proper policies, none of the rest of this is going to have that much effect. I mean, this is a sine qua non and we don't dwell on this enough, the fact that it's a sine qua non.

Senator PROXMIRE. Mr. Secretary, you say on page 5 of your testimony, "Although the high dollar is a major contributor to our trade deficit, it still accounts for only 40 percent of the problem."

Mr. BALDRIGE. Yes, sir.

Senator PROXMIRE. That means, if I calculate correctly, that even if we get the dollar at the right exchange rate against other currencies, we will still have a $90 billion annual trade deficit. Deficits of that size are just unacceptable. If the dollar is only 40 percent of the problem, what are the rest of the causes? Is the LDC debt 10 percent of the problem? Can you give us the other causes and the percent of the deficit they account for?

### OTHER CAUSES OF THE TRADE DEFICIT

Mr. BALDRIGE. Well, I would say that there are three other causes that roughly would be 15 percent of the problem and then one other cause I'd like to mention that it's difficult to put any number on.

I think the swing in the LDC ability to buy our exports—that would be their imports—amounted to almost $21 or $22 billion because of the IMF strictures on them. They couldn't push their exports up enough so they cut their imports back and that hurt us. That was about 15 percent of the trade deficit, a $22 billion swing.

I suppose another 15 percent factor, somewhere in that order, is the fact that the industrialized countries, as distinct from the LDC's in Europe, for example, the rate of growth of their GNP's was distinctly slower than ours. So as our GNP growth was sucking

in imports, our exporters didn't have a growth market to export into. It was a very stagnant market. I think that caused another 15 percent.

And I think the competitiveness, the management ability if you will, the ability to go out there and be hungry for exports, learn to do business in foreign countries and so forth when they haven't had to before, of American industry has really been a drawback on us.

Senator PROXMIRE. Don't you give any weight at all to the refusal of the Japanese to open up their own markets?

Mr. BALDRIGE. I'm sorry. That was going to be the last one. The unfair trade practices I would give a weight of 15 percent at least and it could be a little more. The fact that other countries abroad, such as the Japanese, did not open their markets to us would be the other piece of that puzzle.

Senator PROXMIRE. Fifteen percent isn't a great deal but it's still significant. So why does the administration oppose initiatives by the Congress to give the President new powers to deal with that problem?

Mr. BALDRIGE. We don't think they would work, Senator, in most cases. I don't know which specific one you mean, but when you mandate certain actions unless certain very specific goals are met as in the case of some of the bills, the trading world just doesn't respond to that correctly.

Senator PROXMIRE. So you think there's nothing we can do about it?

Mr. BALDRIGE. No, sir. I think there's a lot we can do about it. The dollar is going to change and that's going to have a big effect. Our industry has to get more competitive. This kind of competition is going to be with us forever. If we block it off we're simply going to make it that much tougher for the LDC's ever to come back, plus our own exporters. You just can't put barriers around the United States without having barriers put up abroad. We're going to see that in the GATT. We're seeing it in the big fight we're having with the European Community enlargement where they're trying to put barriers up against us and we're retaliating and there will be counter-retaliation. We're going to hang in there on that. That's not to worry about. But if we start to say every country that has over a certain trade deficit size with us has got to reduce it 10 percent a year for 4 years or we're going to take a baseball bat to them, that simply won't work, I believe.

Senator PROXMIRE. Thank you, Mr. Chairman.

The CHAIRMAN. Senator Riegle.

Senator RIEGLE. When President Reagan's Commission on Competitiveness reported that we needed a structural change on trade in the Government itself and they recommended that we set up a Cabinet position on trade in order to start to crack this problem open. I'm sure you remember that. You supported that, did you not?

Mr. BALDRIGE. Well, you might say I originated it. I certainly supported it.

Senator RIEGLE. But it was not accepted, was it?

Mr. BALDRIGE. The administration supported it in the first year and I think it was in 1982. Then in 1983, I think it came up and in

a Cabinet meeting with the President we discussed this plan and the vote was 12 to 1 against it. I was the one. So the President said, "Well, we'd better not run that by the Congress this year. We have other priority issues." I was not able to get that through. There was just too much opposition inside the administration.

Senator RIEGLE. Well, I gather a lot of it was from the Secretary of State who has a somewhat different agenda, but I think it's striking—and I'm glad to have you tell us that, that there was a vote of 12 to 1 and the person who really has experience out in the manufacturing sector of the economy was on the short end of that 12 to 1 vote.

But let me just tell you where I think we're heading here because I just want to show you a couple of charts that I've been using in discussions that I've been having with business audiences because I find that they express this problem more powerfully than any words can do and I want to make a point and I'll just take a second to do it.

If you look at the trade deficit here in terms of what's happened on a timeframe—let me hold it up here so you can see it—you can see that we were doing all right up through the late 1970's and then things started to give way and then we hit a plateau, held there and then in about 1982 this thing really broke open and we got on this exponential trade deficit curve which really was radically different than anything we had seen before, a dramatic change in circumstances.

NO. 1 ON THE DEBTOR NATION LIST

Then if you think of that as the income statement and this is the balance sheet and this is the thing that also really worries me because I don't think we understand yet enough as a nation, the implications of becoming a debtor after nearly 70 years. What's more as you, yourself, say within a year we're going to be No. 1 on the debtor nation list, past Mexico, and Brazil.

I'm frank to say I can't find anybody today who really understands well enough the enormous change in dynamics of the world economy to understand quite what it means to be a debtor nation of that magnitude. I'm not talking about where we are now, but where those lines are taking us 1, or 2, or 3 years from now in terms of getting the foreign capital when we need it, especially without having to raise interest rates too high.

And the thing that concerns me here—and I'd like you to sort of step out of your job for a minute and step into the future——

The CHAIRMAN. Senator Riegle, if I could interrupt you for just a moment, we do have a roll call. If you would like to continue, I will go vote and when you're finished if you'll close down with Secretary Baldrige and I'll pick up the new witnesses when I come back.

Secretary Baldrige, thank you for coming.

Mr. BALDRIGE. Thank you.

Senator RIEGLE. Here's what I'm concerned about. The day is going to come when you're going to leave the job you're in and I'm not going to be in this job and hopefully if we live long enough we're all going to look back on this period and we'll be able to make somewhat more sense out of it than we can today.

I see these changes as being so fundamental in terms of changing our economic circumstances. I cited just one company in Michigan. I could have cited 500 all over the country because it's a great interest of mine and so I've made it a point to understand a lot of it. What I'm afraid is happening here is that we are fundamentally impairing ourselves for the future in that while there's a lot of talk that things are getting better and, with all due respect, 1 year ago the word was things are getting better and 2 years ago the talk was that things were getting better. Well, they never really got better and you're now saying we're going to see an improvement in the second half of the year but again, if the best we can do is get a 5-percent improvement in the second half on the Japanese trade deficit in terms of imports into Japan in light of the history of barriers and everything else, that's pretty weak and it isn't going to put much of a dent in these trend lines when you take everything else into account.

So what I'm concerned about when we get out into the future and look back at this time, whether it's your stewardship, the Reagan administration, our stewardship in the Congress, and we take a look at financial circumstance and becoming a debtor nation, the hemorrhage of capital out of the country, the hemorrhage of jobs out of the country, I'm afraid we're going to look back and we're going to say to ourselves:

> The United States got put into a very adverse circumstance and that our future prospects were substantially diminished and it happened in this timeframe, and for whatever the reasons, we didn't understand it and we didn't make the changes we should have and we didn't make the Cabinet lineup adjustments or whatever it is, we didn't do it.

So we've inherited a different situation.

I'm afraid that's happening. That's what the numbers show me. I look at last month's numbers. When you were at Scovil and you looked at the number, you had managers come in telling you that the situation was getting better and better, and yet you've got those monthly statements. When those numbers don't change, when they stay as bad as they are month after month after month, despite all of the sweet talk that things are getting better, when is the point at which you say to yourself, "We're kidding ourselves. We don't have the right lineup. We need the structural changes. We need new strategies. We need other things." At what point do we do that?

I've been expecting that somebody one of these days is going to sort of blow the whistle on this and that it might be you that did it because I think you understand the problem better than anybody else, but I don't see it happening and I don't see the numbers getting any better.

Mr. BALDRIGE. I really do feel confident about those trade figures starting to go the other way in the last half, and I think we'll see the major effect of the dollar in 1987 for the year as a whole, and I think we could see a substantial diminution of the trade deficit. Now not down to perhaps where you'd like to see it, but $100 billion or something like that or below $100 billion instead of being up at $150 billion.

Second, I have the same worry you do about the United States being a net debtor nation. We've been there before, not just in 1914

but during the 1870-80's—I don't know the exact decade but that was close to it, where we were building the railroads, putting in a lot of infrastructure capital, canals, things of that nature. Then we became a debtor nation in order to build up the nation's goods supply and in effect provide more jobs and a base for future industrial growth.

Now we're becoming a debtor nation because we are spending more than we're saving and that's an entirely different reason. And that's what concerns me and I think that's the point that you're making.

Senator RIEGLE. And we're exporting a lot of capital. I mean when we buy a video recorder or a car or whatever and exchange dollars for goods, it's a net outflow of the scarce savings we do have.

Mr. BALDRIGE. Now when you say how bad is it, without reverting to economic language, if this goes on for 3 or 4 or 5 years before the trend reverses, this country is certainly big and strong enough to stand that. I don't know where the breaking point is, I mean where we really start to notice some trouble—if it goes on for 7 or 10 years or what size it would get to. We haven't been there before so anything you'd say is a guess. But clearly, we do not want to go on being a country that spends more than we save. That is going to get us into trouble sooner or later. I just don't know the exact date. It means that we're living beyond our means. We will be living beyond our means if this continues. We will at some time have to pay the piper and that means a reduced standard of living for our children and grandchildren unless we do something to get this under control.

Senator RIEGLE. You know that's happening now. If you look at the data on the standard of living for middle class families it's somewhat misleading because you now have so many families where there are two people working to generate the same amount of real income as one worker in the family used to generate a few years ago. There are an awful lot of people in this society today that are treading water and are sliding backward. The middle class, particularly in the manufacturing related areas of the economy is really in trouble.

I would just say to you—I've got to go and vote here too—that is, I don't think we've got 7 years here before we cross over and find ourselves fundamentally impaired. I think it's much sooner in than that as it relates to the balance sheet aspects, to the insufficient savings rate, to the low productivity rate. We're about to tilt the Tax Code in such a way that we're going to load $100 billion of additional cost on the business sector which you're saying has got to become more efficient and that's going to make it even harder to do that in many respects. We're going to do away with the investment tax credit and so forth. I don't think we've got 7 years and I'm not sure we've got 5 years.

I think if these trend lines run another 3 or 4 years that we will have damaged ourselves enough that we will all have failed. I think the historic judgment will be that no matter how hard you may have tried or we may have tried here, that we just weren't up to the job and we didn't force the changes at the time they needed to be made. I really see it happening and I'm very distressed about

it. I'm not just speaking from a Michigan point of view. That's too narrow a point to work from. I see it all over the country. My colleagues are telling me about this in every single State. The highest unemployment is down in Louisiana right now and it's not just oil and gas—that's part of it, but it's other things as well.

So I don't know what we do here but we're going to have to do something different than we're doing and I think to just continue to say that things are OK and that the changes that we need are in place and if we're just patient we're going to get there I just think is not the truth.

Mr. BALDRIGE. Senator, will you allow me to cheer you up a little, or try to?

Senator RIEGLE. Yes, I'd love you to cheer me up.

Mr. BALDRIGE. People talk about this economy being soft, having soft spots right now. Some economic forecasters are talking about a recession potentially coming.

#### GOOD EFFECTS WILL SHOW UP IN THE LAST HALF OF THE YEAR

Let me say this—and this is from a businessman's point of view that I think is very understandable. The two big problems we've got beside agriculture are the trade deficit—that's going to change in the last half of this year; and the oil price decline which is hurting the people in the Southwest. Both in the trade deficit and the oil price decline we are seeing now in the first half of this year the bad effects of it because they happen first. The good effects of both the oil price decline and the trade deficit change are going to show up in the last half of this year.

Now couple that with the fact that one of the leading indicators that's not that much noticed is real disposable income which was up almost 6 percent in the first quarter, that's income after taxes and after inflation. That's really what you have to take to the bank or to the store. And that was up and did very well in the first quarter. So I think we're going to see a stronger second half and I think it's already baked in the cake.

Senator RIEGLE. Well, I hope you're right. Even if we are, I think these fundamental problems are really in a different category.

Thank you for coming. I've got to run for the vote and I think they're not intending to ask you to stay longer, so I appreciate your being here.

Mr. BALDRIGE. Thank you.

[Whereupon, at 11:20 a.m., the hearing was adjourned.]

[Response to written questions of Senators Heinz, Mattingly, and Proxmire from Malcolm Baldridge follow:]

RESPONSE TO WRITTEN QUESTIONS OF SENATOR HEINZ FROM
MALCOLM BALDRIGE

QUESTION (Senator Heinz #1):

In recent years, we have seen an increase in overall U.S. employment but a decline in manufacturing jobs. As U.S. exports recover with the realignment of exchange rates, are we likely to see new growth in manufacturing employment?

ANSWER:

Manufacturing employment in 1985 was about 7 percent below its 1979 peak, largely because of productivity increases, but also because of a decline in the volume of U.S. exports. Indeed, U.S. export volume in 1985 was still about 20 percent below its 1980 peak even though the current dollar value of U.S. exports is only 3.5 percent below 1980 levels. Manufacturing employment would be significantly larger if U.S. manufactures exports had grown in parallel with manufactures imports.

Manufacturing output and employment are greatly affected by productivity changes and export volume. With the realignment of exchange rates, U.S. exports should become more competitive and begin to grow. I expect this will lead to increases in output and employment in certain manufacturing sectors. On the other hand, enhanced productivity will tend to hold down the overall growth of manufacturing jobs.

2
HEINZ-BALDRIGE

QUESTION (Senator Heinz #2):

Do you believe our trade deficit has a significant "structural" element which will not go away even if the dollar drops significantly? In particular, is our trade deficit with Japan a structural problem, and in what areas?

ANSWER:

These is no inherent "structural" element in our trade deficit that is completely resistant to exchange rate movements. If the dollar fell far enough, and a low dollar were maintained for a sufficiently long period of time, our trade accounts would eventually move into balance and, perhaps, even into a surplus situation. A significant drop in the dollar's value sufficient to achieve this outcome, however, is not desirable. A precipitous fall in the dollar could rekindle inflation and jeopardize future U.S. economic growth.

The recent large U.S. trade imbalances primarily reflect our national macroeconomic performance and policies relative to those of other countries and our domestic investment and saving behavior relative to investment and saving abroad. Many of these policies have structural elements and structural change takes time. The U.S. economy must gradually adjust to "living within our means"--that is, to limiting our consumption, investment, and government spending to what we currently produce. Our major trade partners--mainly Japan and West germany--will also have to adjust to greater reliance on domestic demand and less dependence on export surpluses to generate economic growth.

As regards Japan, we normally run a bilateral trade deficit with that country. In relative terms, our bilateral trade deficit with Japan was the same in 1985 as in 1980--in both years, the U.S. trade deficit with Japan was equivalent to around one-third of the global U.S. trade deficit. Japan must import virtually all of its oil and other raw materials, so it invariably runs a trade surplus with the United States and other developed countries to offset its perennial trade deficit with OPEC and other oil and commodity exporting countries. Under "normal" exchange rate conditions, we would expect the United States to run trade deficits with Japan, Canada, and OPEC countries and bilateral trade surpluses with most of the countries of Western Europe and Latin America and with the centrally-planned economies.

The major "structural" problem underlying our trade deficit with Japan is macroeconomic. For the last five years, Japan has run trade and current account surpluses. This situation has persisted too long. Japan must take steps to correct this imbalance through the adoption of fiscal and monetary policies to stimulate domestic demand, which will help to increase Japan's imports and reduce its exports.

3
HEINZ--BALDRIGE

QUESTION (Senator Heinz #3) :

When will major project activity (such as power plants, manufacturing plants) resume in the LDC's? What are the probabilities that the U.S. will be a strong competitor for this business when it does resume, given recent U.S. price uncompetitiveness and virtual absence from many LDC's markets in recent years?

ANSWER:

Major projects activities in LDC's have decreased in recent years. Many LDCs have been hard hit by weak economies and debt problems. They have had to cut back on planned capital outlays and postpone many major projects. Their need for these projects remains strong. As their economies improve, it is likely that these projects will be resumed. Projects funded by foreign aid grants and the various multilateral development banks continue to go forward.

Chances are good that U.S. companies will be strong competitors for projects that come on-stream in LDCs, but probably as members of a joint venture or consortium, specializing in certains aspects of the project, rather than as prime contractors. Although they are anxious to obtain LDC projects, American firms face obstacles which greatly hinder their ability to win contracts. Among these are competitors' concessionary financing, traditional purchasing and political relationships. The dollar's decline vis-a-vis other major currencies no doubt will help U.S. bidders, but of greater importance in winning contracts is the ability to offer adequate and competitive financing for the project.

QUESTION (Senator Heinz #4) :

The LDC markets accounted for about 40 percent of all U.S. exports prior to the LDC debt crisis and increase in the value of the dollar. How important are the LDC markets likely to be for U.S. exports over the next five to ten years?

ANSWER:

Although the LDC's share of U.S. exports has fallen from about 40 percent before the debt crisis and the dollar's dramatic appreciation to 33 percent in 1985, they are still highly important U.S. markets. It is important to recognize, however, that as long as the flow of new capital to LDC debtor nations is restricted, they will need to continue export drives and to restrict their imports. In such an environment, it will be very difficult to boost U.S. exports to these countries significantly, since they must maintain trade surpluses to enable them to service their foreign debts.

In this age of fierce and growing competition in international trade, every market is important for the United States. I believe that a "solution" to the debt crisis along the lines of Secretary Baker's initiative will allow the troubled debtors to resume more normal import patterns. When this occurs, U.S. firms must be ready to take advantage of the opportunities.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR MATTINGLY FROM MALCOLM BALDRIGE

QUESTION (Senator Mattingly # 1) :

Mr. Secretary, Title Five calls for the elimination of the International Monetary Fund's Compensatory Financing Facility. The CFF, as you know, provides temporary assistance to countries to allow for economic diversification instead of unproductive reliance on a single low-return industry. It appears, however, that much of this assistance is used to do little more than prop up that existing, low-return industry. Title Five would simply return CFF funds to the IMF's general fund. Mr. Secretary, I wondered if you could provide us, for the record, your assessment of the CFF program and your position on any proposed elimination of the program.

ANSWER:

The CFF offsets temporary shortfalls in the export earnings of individual developing countries that are expected to be reversed. The CFF should be retained because, in my view, it serves a legitimate need, stabilizes the economies of the developing countries, and indirectly fosters a better climate for U.S. trade.

The primary purpose of CFF loans is to offset adverse fluctuations in the overall export earnings of individual countries. The prototype case is a developing country that is highly dependent on export earnings from only one or two commodities, such as coffee. Such earnings can fluctuate greatly due to factors beyond the control of the exporting country, such as weather conditions or sharp price changes, and can severely disrupt the country's economy and its balance-of-payments. The International Monetary Fund (IMF) introduced the CFF in 1963 to provide partial relief in such balance-of-payments circumstances.

From a trade standpoint, volatile fluctuations in export earnings can cause a country's ability to import to swing correspondingly from feast to famine from one year to the next. This can be disruptive not only for the country, but also for U.S. firms that seek to sell in the market and might have invested in establishing a market presence. By offsetting losses of export earnings, the CFF can sustain a country's ability to import from the United States and other sources.

More broadly, I would observe that the export industries involved are not necessarily inefficient, but may represent the best use of available local resources. In any event, the beneficiary of a CFF loan is the country involved and not a particular industry. While I agree that diversification is preferable, that may be a long and difficult process. I also note some recent improvements in the program, such as more market-oriented policies, tighter conditions on CFF loans, and scaled back access to the program. With these improvements in mind and the desire of other governments for the program, the Administration and I support the retention of the CFF and oppose Title V.

2
MATTINGLY--BALDRIGE

QUESTION (Senator Mattingly #2) :

Mr. Secretary, during yesterday's joint hearing Senator Heinz asked Secretary Baker what would ensure the cooperation of nations such as West Germany and Japan. I think we are all aware of the inherent dangers of attempting to coordinate the economic policies of seven sovereign nations. Secretary Baker replied that Japan and West Germany would realize that, in the U.S., trade deficits are no longer politically supportable. I am concerned by what I feel is a somewhat naive answer. We already understand that Prime Minister Nakasone is coming under intense political pressure in his own country as Japanese goods and services see increasing competition. Do you see a binding force that will contribute to the success of this initiative and, if so, what is it?

ANSWER:

The U.S. trade deficit is not just a U.S. problem. It is a global problem. It is a problem that threatens the growth and functioning of the international trade and financial systems. The current huge imbalances in trade--the very large U.S. deficits accompanied by very large surpluses for Japan, West Germany and some other countries--cannot be sustained indefinitely. I believe our major trading partners recognize this fact and understand the potentially disastrous consequences on the world trading system of prolonging the current situation.

If existing imbalances are not narrowed in an orderly fashion, the United States and its trading partners run two major risks. First, protectionist pressures may overwhelm good judgment, producing trade restrictions that risk trade wars and great harm to the international trading system. Second, if huge trade deficits and the rapid growth in the U.S. debtor position continue unabated, international investors may no longer be willing to lend huge additional sums to the United States.

The huge U.S. deficits--and the complementary huge surpluses of other countries--must be sharply narrowed. The question before us is what will these inevitable adjustments mean to the world trading system?

This coming adjustment will be difficult not only for the United States but for its trading partners. For the last few years, growing trade surpluses with the United States have stimulated several foreign economies. But shrinking U.S. trade and current account deficits will, in themselves, lower foreign growth potential. The effects on some foreign country manufacturing sectors may be significant, forcing structural changes that may increase protectionist pressures abroad.

A fundamental cause of the current imbalances is disparate macroeconomic policies and developments in the United States and abroad. Coordinated action will be needed to bring policies into better alignment. The United States must take actions to get a better balance between our saving and our needs for investment and the government deficit.

At the same time, the United States cannot indefinitely serve as the only engine of free-world economic growth. West Germany and other European economies can take additional actions to increase growth prospects and beneficial industrial restructuring. Japan, particularly, must adopt policies designed to generate more growth from domestic demand rather than relying so heavily on foreign demand.

To summarize, the difficult task ahead is two-fold: first, to shrink existing imbalances--both national deficits and national surpluses--to sustainable levels while maintaining and enhancing an open international trading system, and second, to coordinate national policies in a way that precludes unduly wide swings in balances in the future. I believe our major trading partners realize the current situation is not sustainable and that greater cooperation between us is necessary to forestall any serious damage to global economic health.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR PROXMIRE FROM
MALCOLM BALDRIGE

QUESTION (Senator Proxmire #1) :

A report released on Saturday by the Joint Economic Committee, on which I have served for over 20 years, notes that the Administration third world debt policy favors U.S. banks over U.S. manufacturers and farmers. It contends that the emphasis on making sure the debtor countries use their foreign exchange earnings to pay interest on their debt means they cannot buy U.S. exports. It suggests that one possible way out of the debt problem would be to limit interest payments on outstanding debt to a certain percentage of each debtor nation's export earnings - and to specify that banks must write down the value of their outstanding loans by a certain amount during every year in which Latin debtor nations hit this revised interest payment target. What do you think of such a proposal?

ANSWER:

I do not agree that Administration third-world debt policy favors U.S. banks at the expense of U.S. manufacturers and farmers--or members of any other sectors of the U.S. economy. The Baker Plan, a key element in U.S. policy toward high-debt developing countries, is directed toward strengthening the economies of these countries. To the extent that the Baker Plan is successful, it will stimulate export demand by developing countries and put that demand on a more secure footing. The beneficiaries will include U.S. exporters of manufactured and agricultural goods. The Baker plan, furthermore, is in no way biased in favor of U.S. banks. As you know, the plan calls for expansion of lending over the next three years by commercial banks and multilateral lending agencies and encourages adoption by the recipients of policies that will move their economies in a more market-oriented direction. In urging them to increase their loans to developing countries, the Baker plan is offering U.S. banks no concessions in the form of loan guarantees and the like.

As for the proposal that interest payments be restricted to a certain percentage of earnings and that loans be written down in return for compliance by the debtor countries with the scaled-down interest-payment obligations, it is difficult to comment without knowing what specific quantities the proponents of this suggestion have in mind. For example, the negative impact on bank profits of limiting interest payments to 30 percent of export proceeds might be relatively mild. But if the cap were set at 10 percent, the reduction in interest paid might very substantially reduce the net earnings of U.S. banks or possibly wipe them out altogether.

I would like to make one general point, however. Any debt-relief plan that involves a ceiling on interest payments and writeoff of loans has one serious drawback. By damaging the financial position of the banks, it would magnify their already evident reluctance to increase loans to developing countries. This approach to debt relief thus might be detrimental to the long-term interests of developing countries.

2
PROXMIRE--BALDRIGE

QUESTION (Senator Proxmire #2) :

The report by the Joint Economic Committee which I have just referred to contends that current Administration policies on the debt issue offer the debtor nations little hope that the service burden will be eased any time soon - and that thus their leaders would come under increasing pressure to declare a debt moratorium. Such a moratorium could force several large banks into financial ruin. The report maintains it would be wiser public policy to have the banks write some of these loans off and reduce interest payments on them, both of which would reduce bank profits - but over time could help them by avoiding a debt moratorium. Can you comment on this aspect of the JEC report?

ANSWER:

If the only alternative is a total moratorium on debt service payments or repudiation of debt, then, clearly, a partial writeoff of loans and a reduction in interest payments is preferable. But I do not accept that these are the only two possibilities, nor do I agree that Administration policies offer little hope of easing the debt burden that many developing countries must deal with. Once again, I want to stress that the Baker Plan is designed to help improve economic performance in developing countries so that, among other objectives, they can adequately service their debt and avoid future debt crises. The Plan also aims to help tide these countries over while they are taking the necessary steps to strengthen their economies. One of these necessary steps is ending and reversing capital flight, which, as I said in my May 14 testimony, has been both a cause and a result of the debt problem.

I would also like to point out that the debt-servicing burden of many developing countries has actually eased in recent months. The collapse of oil prices has enhanced the debt-servicing capacity of oil-importing countries, both because of reduced expenditures on oil and because of lower interest rates. Decreased oil prices have been a blow to oil-exporting countries, of course, but the damage done to their ability to service their debt has been at least partially offset by the fall in interest rates.

3
PROXMIRE--BALDRIGE

QUESTION (Senator Proxmire # 3) :

In your February presentation before our Committee you also told us another major cause of our trade deficit was the loss of sales to developing countries because of the debt problem. They were restricting their imports, you said, because they could not afford to pay for them. This was the result of using their available foreign exchange to pay interest on their outstanding debt.

At that time you mentioned that "mundane 90-120 day kind of trade credit was drying up" because of the larger debt problem. I have been wondering if there is any way that trade financing and the repayments on short-term trade financing can be separated from other aspects of the debt problem. Has the Administration undertaken any initiative in this regard? Is any consideration being given to changes in bank regulatory procedures that would permit banks to write off their long term loans over a period of years so that new short term trade financing can go forward unimpeded by their presence?

ANSWER:

I agree wholeheartedly on the desirability of separating short-term trade financing from other aspects of the debt problem. Some debtor countries appear to have recognized this also and taken steps, when they run into repayment problems, to maintain payments on their short-term trade credit to ensure continued financing for their vital imports. Although there is no systematic policy, the Administration as a practical matter has sought to maintain the flow of trade credit to debtor countries and urged prompt payment of trade receivables. We have made government trade credit lines available in selected instances through the Export-Import Bank and the Commodity Credit Corporation in order to sustain U.S. trade and to provide a signal of confidence to private traders and lenders. And, short-term debt is generally not rescheduled under Paris Club procedures, a rule that reemphasizes to debtor countries the need to repay such debt on a timely basis.